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# SAN FRANCISCO TAX STUDY

*report to*

FINANCE COMMITTEE  
BOARD OF SUPERVISORS  
CITY AND COUNTY OF SAN FRANCISCO



Arthur D. Little, Inc.



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**Report to**

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William C. Blake  
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Terry A. Francois  
Leo T. McCarthy  
Jack Morrison, Chairman of  
Finance Committee  
Kevin O'Shea  
Peter Tamaras  
Mrs. Dorothy vonBeroldingen

***Arthur D. Little, Inc.***

**C-69228**

**July 1967**

\* 352.1

L721s

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## THE STUDY AT A GLANCE

### SAN FRANCISCO'S TAX DILEMMA

This year most San Francisco homeowners will be faced with the highest property tax bills in the City's history. Their bills will reflect the impact of the Petris-Knox Act (AB 80), which requires assessment of all property at 25 percent of full cash value. The Act upsets a long-standing but tacit San Francisco property taxation policy, expressed in assessment rates: that commercial enterprise should bear a higher proportion of City government costs than residential taxpayers. While commercial and industrial property has been assessed at near 25 percent, residential property has been assessed at about half that.

A great many interested citizens will want to know what can be done to lighten their burden. Anticipating their concern, the City of San Francisco retained Arthur D. Little, Inc., to investigate the probable effects of AB 80 and to explore alternative methods of taxation that, singly or in combination, would enable San Franciscans to restore the traditional balance among revenue sources. Besides considering taxation alternatives, we have also looked into user charges, Federal aid possibilities, and property tax exemption inequities.

### THE IMPACT OF THE PETRIS-KNOX ACT

Reassessment of City property at 25 percent of full cash value will change the size of the assessment roll in the following ways:

- The size (value) of the roll will increase by about half a billion dollars.
- Virtually all of this expansion will occur within one property class--residential. Industrial and commercial property values will actually shrink slightly while residential valuations will increase by about \$525 million.

Reassessment will produce marked changes in the relative tax liabilities of the owners of the various classes of property:

- Residential property owners were traditionally liable for only one-third of the City's total property tax bill; now they will be responsible for paying one-half. Property owned by the business community will now produce the other half of the total instead of its previous two-thirds.



- More specifically, the reshuffling of relative tax liabilities of the owners of the various classes of property will lead to a tax increase of about \$29 million for residential property owners; those owning older, single-family dwelling units will bear the brunt of the increase. At the same time, the business community will realize a tax windfall since their tax bills will be \$29 million lower than they otherwise would be.

A \$29 million reassessment-engendered increase in tax liabilities for residential property owners will have serious effects on the housing market and the tax bills of City residents. Among the more serious of these effects will be:

- Increases in the tax bills for owners of single-family dwellings, ranging up to about 240 percent of last year's bills.
- Large increases in the property tax burden for many City families. For example, households consisting of white adults with children earning between \$4,000 and \$10,000 will be paying about 80 percent more in property taxes.
- Decreases in the market value of dwellings by perhaps as much as 15.5 percent in the case of single-family structures.

#### WHAT CAN BE DONE?

The City does not have to take a passive stance in respect to these developments. The City may cushion the harsh effects of reassessment by imposing business and other non-property taxes that would divide the City's tax liability along more customary lines. In so doing, the City would insure that both the City's residents and the business community, respectively, would continue to contribute what has traditionally been regarded to be their fair shares to financing City government. The alternatives available are a business tax, a personal income tax, several new excise taxes, and increased charges to users of publicly subsidized utilities.



## A Business Tax

Of these alternatives, a business tax designed to yield about \$25 million has the greatest capacity for directly remedying the present problem. A tax of this size will not fully correct the City's reassessment-engendered tax imbalance; a business tax of \$58 million would be needed to accomplish full correction given the new 50-50 split in tax liabilities. But the tax would show the willingness of both, the business community and the residents, to face up to the very real and the very large problem posed by reassessment. Therefore, the City should consider one of the following business taxes:

- A gross margins tax levied at 0.5 percent
- A gross receipts tax levied at 0.2 percent
- A net income tax levied at 3.6 percent

Each of these levies has various strengths and weaknesses. All are at least as equitable as the property tax. Of the three, the gross margins tax is probably the best.

The City may find that a business tax is not politically feasible at the moment. Although it is unlikely that the business community would be unwilling to contribute its fair share to the City by means of a modest business activities tax (which would not generally increase its overall tax liability since property taxes would be reduced) it is possible that discussions over the appropriate form of business tax could become mired down. In this event, the only tax capable of providing relief for the homeowner would be a personal income tax.

## A Personal Income Tax

A personal earning tax of 1 percent could produce between \$15 and \$35 million, depending on rate structure. Because house ownership and income-producing capacity are imperfectly related, property owners would be better off by having the City exact revenue by means of income rather than property taxation. Income taxation would also provide a method for shunting part of the tax burden to nonresidents, a group which benefits from the City's tax-supported public services, and to residents of other Bay Area communities who, as owners of a substantial portion of the capital employed in the City, will be among the major beneficiaries of the reassessment-engendered \$29 million tax windfall. The following types of income taxes levied at a 1 percent rate have potential yields of the following magnitudes:

- Type I, tax on income earned in San Francisco would yield up to \$32 million.



- Type II, tax on earned income of San Francisco residents and of commuters to San Francisco would yield up to \$35 million.
- Type III, tax on total income of San Francisco residents and commuters would yield up to \$41 million.

#### New Excise Taxes

The City could enact a number of measures relating to excise taxes and raise several million dollars in new revenue. Such measures would not, however, contribute significantly to the solution to the City's central problem, the \$29 million reassessment-engendered shift in tax liabilities from the business community to the residential taxpayers. But there is undoubtedly merit in enacting several tax measures that would decrease the City's exaggerated dependence on the property tax. Among the most feasible non-property measures would be:

- An increase in the hotel room tax from 3 percent to 5 percent. Not only would this measure bring in an additional \$1.3 million, but it would effectively shunt the burden to visitors who do not fully pay for the wide range of public services they receive.
- Adoption by the City of the soon-to-be-discontinued Federal tax on real estate transfers, with one important difference. Small homes selling for less than \$20,000 should continue to pay the extremely mild .11 percent tax; those real properties selling at a price over \$20,000 should pay at least a .667 rate on the value of their property that exceeds \$20,000. The estimated yield of this tax would be about \$835,000.
- Imposition of a 2-cents-per-pack cigarette tax would yield an estimated \$1.7 million.

#### Increased User Charges

User charges constitute another opportunity to raise additional revenues. The performance of many urban functions involves a high degree of subsidy from taxpayers to primary beneficiaries of these services. Where the property tax is a poor indicator of benefits received, as it is in the case of the users of Hetch Hetchy water and power, an increase in user charges is justified at the present time. Where the property tax is a more reasonable measure of benefits received by property taxpayers, i.e.,





the Municipal Railway, there is less reason to increase charges since to do so would not materially change the relative burden of business versus residential consumers to any appreciable degree. It is recommended that:

- Hetch Hetchy Water Supply and Power rates be increased to yield an additional \$3 million a year in revenue.
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- Health inspection fees be increased by \$400,000 annually.
- A charge be instituted at the San Francisco Zoo that would raise \$800,000 annually.

#### INCREASED FEDERAL-CITY COOPERATION

San Francisco must recognize that in the long run, variations of Federal revenue-sharing programs will be extremely important. At present it is not known whether such programs will be channeled through the states to the City or to the City directly. San Franciscans should attempt to shape this emerging legislation to the extent possible and in a way that will insure that the City receives a fair share of any future allocation.



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## ACKNOWLEDGMENTS

This report was prepared by an Arthur D. Little, Inc., research team directed by Alan D. Donheiser. Key participants in the study were:

### Staff

Cyril C. Herrmann, Vice President, Urban and Regional Economics  
William Benton  
Claude Gruen

### Consultants

Mark A. Haskell, Associate Professor of Public Finance,  
Graduate School of Public Administration,  
New York University  
John B. Legler, Assistant Professor, Department of Economics,  
Washington University, St. Louis

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## SUMMARY

### SAN FRANCISCO'S FISCAL PROBLEM: AN OVERVIEW

#### A Shift in the Balance of Tax Burden

Reassessment dictated by the Petris-Knox Act (AB 80) is about to make a dramatic change in the nature of San Francisco's local tax structure. Business and industry will find their tax bills somewhat smaller, while the City's individual residents will find that the contributions they make either directly or indirectly will increase--in some cases, precipitously.

The actual effect of this recent State legislation is to strike down the traditional distribution of the local tax burden between the business community and individual residents. The wisdom of that distribution may be questionable on the grounds of sound planning practice and economic efficiency, but the fact remains that the people of San Francisco did not themselves choose to change the system. Now they must either passively accept a new revenue equilibrium, or else seek new means to re-establish the traditional distribution.

In San Francisco, a pattern of assessment practices developed that insured that homeowners would be treated differently from the business community who owned the City's industrial and commercial property. It was not unusual, therefore, to find single-family, owner-occupied dwellings being assessed at nine or ten percent of their market value and downtown stores being assessed at ratios as high as twenty-five percent or more. While technically illegal under the State constitution, this practice achieved an important but implicit public policy objective; it guaranteed that the business community would make a consistently larger contribution to City government than would the individual taxpayer. The endurance of this de facto classified property tax, combined with the City's decision not only to avoid but to actually attempt during the 1930's to proscribe other forms of business taxation, stands as mute evidence that a bargain was struck between these two groups. If this were not so, reassessment would have long since been demanded by the business community.

Some may question that any such "partnership" existed since observed irregularities in the assessment process were the result of private rather than consensual agreement. This argument fails on the grounds that assessment ratios varied systematically between classes of property, and these variances were well known. Just because comparable properties within a class, say inventories, may have been at times inconsistently and/or corruptly assessed is irrelevant to the discussion of the existence of a de facto classified property tax. This distinction is important to prevent misunderstanding of the nature of the fundamental

issues posed by reassessment. AB 80 is a well intentioned law and will substantially reduce opportunities for private windfalls created by preferential assessment. However, reassessment will also have direct but completely unintended effects on the composition of the property tax base.

San Francisco depends heavily on the property tax as a revenue source; other taxes provide only slightly more than 10 percent of total local tax revenues. Up to now, about two-thirds of the City's total property tax base was in non-residential and commercial property, the remaining third in residential. The business community has therefore contributed two dollars to the support of City government to the individual resident's one. Individual residents, under AB 80, will have to match the contribution made by business one to one -- dollar for dollar. This "shift" in tax liability will be of considerable significance to the City because it will result both in larger tax bills for individual taxpayers, about \$29 million worth during the coming fiscal year, and smaller ones for the business community. It also means that business will henceforth be called upon to shoulder a smaller part of the burden of paying for the increasing costs of City government.

#### Correction Difficult

The City may mitigate the effects of the shift in tax burdens by imposing a non-property tax on the business community. In other words, though it is no longer possible to use the property tax as a means to differentially tax the business community, it is possible for the City to consider using the property tax in combination with a business tax to extract twice as many tax dollars from the business community as from the owners and renters of residential property. The full implementation of such a strategy would be extraordinarily difficult, however. In order to completely correct an anticipated net shift of \$29 million, the City would have to impose some sort of tax on business that would yield twice this amount, \$58 million. The rather startling size of a corrective business tax is due to the fact that once the budget is set, every dollar raised by non-property taxation is a dollar less that must be exacted by a property tax. If the business community is called upon to pay a non-property tax, it would recoup 50 cents on every business tax dollar by paying less in property taxes. In a sense then, residential property owners would "pay" one-half of any taxes on business as long as property tax liability was split 50-50 between the two. Hence, full correction would call for a business tax twice as great as the amount of the shift in tax burden created by reassessment. However, as will be shown, the goal of full correction is neither practical nor desirable.

This study has employed the working hypothesis that both the business community and the City's residents want to continue contributing what they have implicitly regarded as their "fair share" toward keeping San Francisco the

culturally exciting, urbane, progressive, and inspiring City that it is. However, this "partnership" must recognize the advantages and disadvantages of correcting the shift by diversifying the tax structure. There is no way of insuring that for any given firm the decrease in property tax liability would be offset by an exactly equal increase in business tax liability. Full correction would result in massive increases in the tax bills for some firms; alternatively, many firms would reap windfalls no matter what type of business tax is employed. Only in the aggregate could full correction be realized. On the other hand, it is evident that failure to enact any new tax measure specifically designed to offset the shift induced by AB 80 will result not only in onerous increases in the tax burden for many homeowners, but also in a dead weight load on city-wide housing values. A compromise solution involving both partners therefore appears desirable.

## IMMEDIATE IMPACT OF REASSESSMENT

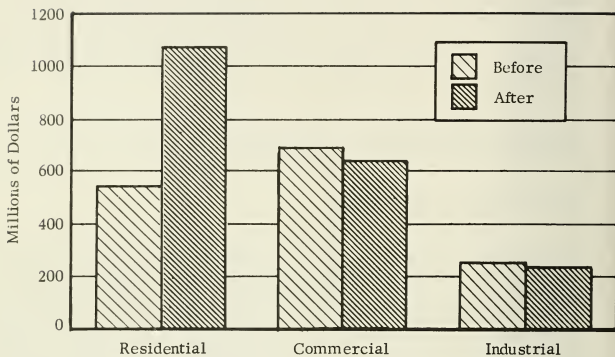
### Explicit Effects on the Tax Base

Application of a 25-percent standard assessment ratio to locally assessed property will enlarge the City's property tax base by \$476 million.<sup>1</sup> This expansion will be peculiarly selective since only residential property will be adjusted upward; revenue production of the other classes will shrink somewhat. Residential property was assessed, as a class, at about half the Assessor's announced twenty-five percent ratio; the rest, at or above it. Figure 1, based on State Board of Equalization (SBE) appraisal/assessment ratios for locally assessed property, illustrates the distribution of the tax base before and after reassessment. Single-family, owner-occupied dwellings will be most vulnerable to reassessment as many of these units, particularly those built before World War II, have been assessed as low as 9 percent of their market values. Apartment houses, most notably the newest and largest, have been assessed at ratios close to the twenty-five percent market. However, the older, smaller dwelling units predominate in the City, and collectively, they pull the average residential assessment ratio down to about 12.8 percent of market value.

Because these ratios were systematically different for the various property classes and because the City relies so heavily on property taxation, reassessment will alter not only the absolute size (value) of these components of the tax base, but their relative liabilities as well. The reasoning behind this statement is quite simple. The City can no longer impose a different tax rate

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1. Estimated on the basis of State Board of Equalization data for 1965-66.



Source: See text.

FIGURE 1 ESTIMATED DISTRIBUTION OF LOCALLY ASSESSED TAX BASE BEFORE AND AFTER REASSESSMENT



on different classes of property. It must impose a flat rate ad valorem tax without discrimination. Traditionally, however, it was possible to impose an effective differential rate by changing assessments for any given class upward or downward.

Thus it was that commercial industrial and utility property became liable for two-thirds of the total tax burden even though they accounted for less than one-half the gross market value for all property within the City.

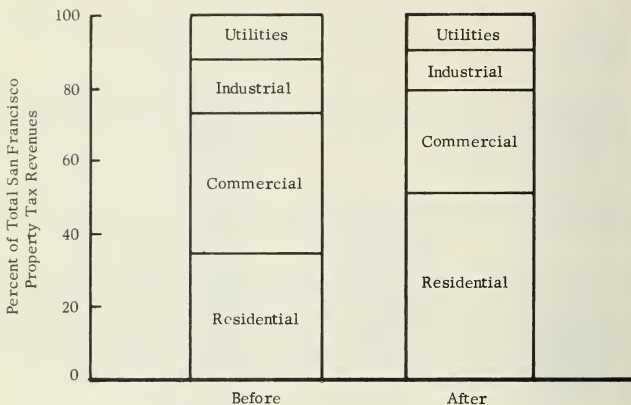
The shift in tax liability (see Figure 2) means that residential property tax liabilities will be increased by about \$29 million and commercial-industrial-utility decreased by an equal amount. This sudden change will have substantial repercussions on City households, real estate, and business.

#### IMPACT OF REASSESSMENT-ENGENDERED TAX CHANGES ON HOUSEHOLDS

No one can foretell exactly what effects increasing residential tax bills may have. However, by taking into account household income, ethnic background, and type of dwelling unit as well as value and assessment level, it is possible to envisage several possible outcomes to tax increases. For purposes of analysis two possible reactions were posited. The first incorporated the assumption that tax increases would be directly absorbed out of current family income. The second assumed that higher tax rates would be felt in lowered property values.

Findings based on the first assumption indicated that there will be three major household groups that will pay on the average 75 percent more in taxes after reassessment than before. They are: (1) white households with children, incomes between \$4,000 and \$10,000; (2) white adults with children, incomes over \$10,000; and (3) oriental adults with children, incomes under \$6,000. However, when these tax increases are taken as a proportion of income, the increase in burden does not appear so onerous. Tax increases as a percent of income of these groups should average out to about two percent. This increase would be less than the average annual rate of increase for real income. On the whole then, assessment-engendered tax increases cannot be expected to cause wholesale distortions of family budgets although it is certain that for some families the increase will be difficult to adjust to. Without such distortion an exodus of homeowners is unlikely.

If the main effect of the tax change were reflected in lower property values, it would appear that typical single-family owner-occupied dwelling units could drop in value on the average by as much as sixteen percent. In other words, the tax would be capitalized. As shown in Chapter II, the degree of capitalization



Note: Assumes percent distribution of property tax burden is the same as that of assessed values.

Source: Estimated from SBE appraisal/assessment data for 1965-1966.

FIGURE 2 ESTIMATED DISTRIBUTION OF PROPERTY TAX BILL BEFORE AND AFTER REASSESSMENT--By Property Type

is related not only to the appropriate fractional assessment ratio but to assumed capitalization rates as well. Therefore, some units, particularly large new apartment houses, will feel the impact of reassessment lightly; some may even benefit.

It is probable that the actual effect of increased taxes will be somewhere in between the two cases cited. Some of the tax will be capitalized, resulting in lower property values. The rest will be paid out of current incomes, i.e., absorbed by owners and tenants. It is clear, however, that while they will come as a minor shock for City residents, assessment-engendered tax changes may have a brutal effect on a few individuals and families in all categories, but particularly on elderly people with fixed incomes.

In light of generally higher residential tax burdens existing in the rest of the Bay Area, it is likely that most families are "locked in" and will not choose to move. (If one sells his house he realizes the capitalized effects of the tax in the form of a lower price; the buyer thus can move the burden of future taxes back to the seller. But if he does sell, where does he move? To the suburbs, where residential property taxes are higher?) There will, however, be sufficient reshuffling at the margin to affect some rents and prices throughout the housing market.

In light of the compelling nature of San Francisco's problem and the uncertainty that surrounds the eventual consequences of reassessment, it is entirely appropriate that the City consider a plan of action designed to attenuate the effects of reassessment by means of non-property taxes.

## BUSINESS TAX ALTERNATIVES

Although Section 24 of the City Charter prohibits a license (viz., regulatory) tax measured by gross receipts, there seems little reason why San Francisco, a Charter law city, cannot directly levy either a gross receipts, gross margin (value added) or net income tax on San Francisco businesses. Each of these levies appears fully capable of recouping a sizable portion of the reassessment-engendered \$29 million shift to residential taxpayers. While there is good reason to believe that a gross margin tax would be the best of all possible business taxes under present circumstances, taxes on net income and even gross receipts could also play a pivotal role in the future city tax system. However, before deciding the question which tax alternative is appropriate, the City must decide how much revenue it wished to collect with a business activities tax.

The City must recognize that full correction of the \$29 million shift, though possibly desirable on equity grounds is not a realistic tax policy objective. As has already been pointed out, the splitting of the property tax base between the business community and the residential taxpayer greatly exaggerates the size of the business tax needed to correct the reassessment-engendered shift. This, coupled with the fact that a firm's tax liability may be quite different under various forms of taxation, would undoubtedly prevent the City from levying a business tax with a rate structure high enough to yield amounts adequate to bring the business community's share of the tax bill back to a pre-reassessment parity. To do otherwise would be to penalize unduly those firms that had low property tax liabilities but which had relatively large net incomes, gross receipts, or gross margin liabilities. It is conceivable that some firms would be forced over the brink of profitability and face almost certain extinction if, say, a 7-percent net income tax, a 1-percent gross margins, or a half-percent gross receipts tax were imposed. (These rates would raise almost the amount of the shift.) This would be true despite the fact that, in the aggregate, changes in tax liabilities would just offset one another. In short, assuming the City wants to rebalance the tax structure, it must proceed in a way that insures that the City's business community will not be inordinately discriminated against. Clearly, then, a compromise is indicated.

A business activities tax could be levied at a rate high enough to partially rebalance the system but low enough to permit virtually all firms to be better off than they were before reassessment. A tax yielding about \$25 million would meet these requirements. The City should carefully consider levying one of the following forms of business activities taxes to effect a compromise:

- A gross receipts tax at 0.2 percent
- A net income tax at 3.6 percent
- A gross margins tax at 0.5 percent

Each of these imposts has both strengths and weaknesses that must be considered (see Table 1).

The gross receipts is an appealing tax because it is familiar to businessmen and is a stable and predictable source of revenue. Because its base is so broad, it may be employed with a relatively low rate. Nevertheless, gross receipts is a poor measure of the benefits received by a firm and could hardly be said to have any relation to profitability. The tax also has a disturbing tendency to pyramid -- that is, as a commodity passes through several firms in its production-distribution cycle, each firm may pass along the cost of the tax to the next so the taxable base and the tax increase at each stage.

TABLE 1

EVALUATION OF POTENTIAL BUSINESS TAXES

<u>Criteria</u>	<u>Form of Tax</u>		
	<u>Gross Receipts</u>	<u>Gross Margin</u>	<u>Net Income</u>
1. Resource Allocation			
a. Neutrality in respect to input mix <sup>a</sup>	C	A	B
b. Lack of pyramiding tendency <sup>b</sup> <i>shiftability</i>	C	A	A
c. Neutrality in respect to type of business organization	C	A	A
2. Relation to Benefits Received	B	A	B
3. Stability of Yield	A	A	C
4. Growth Potential	B	B	A
5. Administration			
a. Familiarity	A	C	B
b. Number of taxpayers	A	B	C
c. Administrative costs	A	C	B
d. Height of rate structure	A	B	C

Note: Rating code is ordinal classification: A - best, B - second best, C - third best.

- a. Refers to combination of factors of production, i.e., land, labor and capital used in production.
- b. Refers to tendency of tax to get built into price structure at several points in productive cycle.

A tax on net income could be particularly desirable if it could be imposed as a specified percentage of the state income tax and also collected by the state. This appears to be an unrealistic alternative, at least in the short run, however. The City, nevertheless, could impose and collect an income tax of its own.

The net income tax's strengths would lie in its responsiveness to an expanding economy and in its ability to equalize the burden of taxation amongst industries. The tax's weaknesses lie in: (1) the high rate structure needed to produce yields that other business activities taxes produce with far lower rates; (2) its poor relationship to benefits received; and (3) the existence of difficult administrative and compliance problems related to the allocation of net income of businesses operating outside of San Francisco to the City.

Gross margins or value added appears to offer the most satisfactory base for a new business tax. Although the tax is unfamiliar to most Americans, the computation of the base is not. Gross margins may be defined as the value shipments less the cost of materials, supplies, fuels and the like. In other words, it is the total value of output less the cost of inputs purchased from other firms. The base, while narrower than gross receipts, is substantially wider than net income and therefore permits a relatively low rate structure. More importantly, gross margin is an indication of the output of the firm without regard to whether this output requires heavy inputs of land (perhaps measured by rental costs), labor (including executive talent) or capital. It is far more reasonable to justify a business tax on the basis of gross margin or value added since the value of the services provided by the City to business is more nearly proportional to the amount of productive activity of each firm as measured by its value added. To sum, a gross margins tax would be an excellent choice for the City in view of the need to replace the de facto business property tax with an economically neutral business activities tax bearing a strong relationship to benefits received.

#### A MUNICIPAL PERSONAL INCOME TAX

An individual income tax offers the City an excellent opportunity to diversify its tax structure. The tax is basically a responsive, equitable tax and would be a particularly appropriate one for San Francisco in light of its historic role in providing heavily tax-supported (and subsidized) public services to residents of the entire Bay Area. An income tax would permit the City to recoup sizable amounts of revenue from commuters who, at present, contribute very little to the City in exchange for such subsidized publicly-supported institutions as museums, zoos, and aquariums.

Many possible variations on income taxation exist. As a result, estimates of tax yields vary considerably. It is apparent, however, that in order to make the tax equitable, sizable exemptions must be built into the tax structure. Even so, the City could depend on yields exceeding \$30 million dollars per annum. Because real estate ownership and current income is not well correlated, an income tax could be regarded to be a crude method of providing tax relief for property owners this year.

#### OTHER NON-PROPERTY TAXES

Several opportunities exist for the City to impose other non-property taxes. A higher degree of reliance on selective sales taxes could boost local tax revenues by more than \$10 million. While it may be desirable for the City to levy such taxes as part of a program aimed at diversifying the property tax, it must be plainly understood that these taxes will have little effect on the re-assessment-engendered revenue shift problem. Barring the possibility that the state will pass pre-emptive taxes of its own, there seems no reason why a combination tax package consisting of an increased hotel room tax, a real estate transfer tax and a cigarette tax could not produce more than \$3 1/2 million this coming year. Other less desirable taxes are an extension of the sales tax to cover services, and an amusements tax. Table 2 summarizes an evaluation of the more likely non-property taxes.

#### INCREASED USER CHARGES

There is definitely a role for the City's increasing charges and lowering subsidies for public service enterprises. The City should be able to increase revenue from such sources as sewage disposal, Hetch Hetchy, the zoo, the "Muni," the water department, etc., by \$9 - 16 million dollars annually. However, in light of the current year's problem, it is questionable whether the City's taxpayers would be relieved of their tax burdens by paying sewage charges instead of property taxes. The shift problem is not amenable to solution by, in effect, reshuffling residential taxpayer liabilities. Therefore, the City should consider increasing charges for those activities which involve the greatest opportunity for promoting property tax relief -- health inspection, Hetch Hetchy, and possibly the water department. Eventually, the City must consider putting all public operatives that provide services for individuals (i.e., the benefits are clearly traceable to persons rather than society in general) on a quid pro quo basis.

TABLE 2

## NON-PROPERTY TAX ALTERNATIVES: A DESCRIPTION AND EVALUATION

	Description and Potential Yield			Evaluation		
	New Tax	Change in Existing Levy		Equity	Elasticity	Relation to Benefits Received
		Rate	Additional Revenue (millions)			
Hotel room		X	5%	\$ 1.3	A	A
Real estate transfer	X		.11%-.667% <sup>c</sup>	0.6	B	A
Cigarettes	X		2¢/pack	1.7	C	B
Sales of services	X <sup>a</sup>		4%	12.2 <sup>b</sup>	C	B
Amusements	X		4%	1.4	C	B
Total						
						\$17.2

a. City could not unilaterally extend sales tax agreement to State and would be forced to impose and collect this tax.

b. Rough approximation, see text for discussion.

c. Rate on sales under \$20 thousand, 0.11%; on sales over \$20 thousand, 0.667%.



## CHAPTER I

### THE NATURE OF SAN FRANCISCO'S PRESENT FISCAL DIFFICULTIES

This chapter discusses the size and scope of the problem created by reassessment. Particular emphasis is placed on the quantification of the shift in tax payments from business to residential taxpayers. This chapter, therefore, is designed to frame the analyses and discussions of workable policies which appear in subsequent parts of the study.

#### SUDDEN PROPERTY TAX REFORM

##### Implications of Standard Assessment Ratio for Property Owners

San Francisco is now in the process of implementing the Petris-Knox Act, AB 80, the property tax reform law requiring all taxable property to be assessed at a uniform percentage of full cash value.<sup>1</sup> Because the City has had a long history of unstandardized property tax administration, present corrective action promises to be especially painful for those who had benefitted most from the inequitable system of previous years. Although AB 80 compels local assessors to assess all taxable property at a standard 25 percent ratio of assessed to market value by 1971-1972, the San Francisco Assessor has announced that he will move up to 25 percent ratio for roll year 1967. Thus the City is completely recalibrating a complicated piece of tax machinery in just one year. In doing so, it is very important that the City's resident taxpayers be made aware of the elements and the goals involved in this readjustment, and it is equally important that they recognize realistic policy alternatives which, if implemented, will help suppress the severest economic side-effects of reassessment.

Under AB 80 there will be a significant redistribution of property tax liability--from owners of property now assessed at relatively high ratios of assessed to full value, to owners whose property historically enjoyed low ratios. If, in past years, the quality of property tax administration had been such that overassessed and underassessed properties were randomly distributed among all types of property (e.g., residential, commercial, and industrial), the dimensions of the present problem would be fairly well limited to the individuals directly affected. There is ample evidence, however, that systematic discrimination

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1. State of California Statutes, 1966, Chapter 147.

obtained between residential property on the one hand and commercial and industrial on the other. Moreover, property within each general type was differentially assessed; older, single-family dwellings were assessed quite differently from multi-family apartments or even newer single-family units. When these anomalies are eventually ironed out through reassessment, San Francisco will find that those properties which were most underassessed, i.e., displayed the lowest fraction of assessed to full value, will be responsible for a far heavier burden of taxation.<sup>2</sup> The smaller homeowner is frequently to be found in this category.

Conversely, the owners of commercial and industrial properties which were assessed relatively highly, above the 25 percent ratio, will benefit through reductions in their tax bills.

### The Significance of a Shift in the Tax Burden to Residential Property

If residential property owners were the only ones who worked in, invested in, and owned the City's commercial and industrial base, the shifting of the burden from one type of property to the other would present a smaller problem. That is, San Francisco residents would still be paying the same amount of taxes after reassessment as they were before, despite differences in the way the tax burden is distributed among the City's families. A net reduction in the burden of business property taxation under present market conditions prevailing throughout the Bay Area will mean a net reduction in taxation for the owners of all factors of production, i.e., resources, employed in San Francisco business. However, since much, if not most, of the land and capital employed in commerce and industry is owned by residents of the rest of the region, and even the rest of California, reduction in taxation of business and commercial property will simultaneously produce a tax windfall for owners of these resources and an additional fiscal encumbrance for the City's residents. It is extremely doubtful that San Franciscans would want other residents of the Bay area to make smaller financial contributions to City government, but this is precisely the effect that reassessment will have.

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2. An important caveat with respect to the use of the term "tax burden" should be noted here. Although the term is usually employed to denote the ultimate taxpayer after accounting for tax shifting which occurs as a result of price and output changes in the marketplace, it is used here simply to indicate who has the legal responsibility to pay taxes; where appropriate, mention will be made of the phenomena of tax shifting or incidence and the locus of the ultimate money burden of taxation.

The question of business contributing its fair share to the City in the form of business taxes is one of great importance. Residential taxpayers and the business community share in the benefits of City services. The relative share of each has been determined by history. A partnership grew up between the two that is now being destroyed by reassessment. By dividing the tax base so that the business community paid more in taxes than did households, a de facto classified property tax was developed. This de facto classified property tax should be viewed as the entire community's response to a fundamental problem: who should pay for City government? Seen another way, the de facto classified property tax contains both a property tax and a business tax, however peculiar the forms may appear. Reassessment dissolves this partnership. Reassessment (under AB 80) concerns itself with legal concepts of equity rather than economic realities; this is the basis of the City's problem.

Nor are these the only undesirable effects of implementation of AB 80. There are several specific effects that will occur through reassessment. Increased taxes on residential properties will surely be capitalized.<sup>3</sup> The reduction in market value may well check any buoyancy of the market for single-family dwelling units. Tax increases on residential property may also change long-established neighborhood patterns. Moreover, they may well serve as a catalyst for the promotion of higher-intensity land uses in San Francisco--an undesirable effect if one believes that San Francisco should encourage residency by middle-income families. In short, the problem appears to be of such dimensions that there is really no question that reassessment and the concomitant shifting of the tax burden to residential property if unchecked, will wreak a major change in the character of the Bay Area's urban economy.

#### SCOPE OF THE PROBLEM CREATED BY REASSESSMENT: A QUANTITATIVE APPRAISAL

##### A Note on the Significance of the Data

The following analysis has been based upon State Board of Equalization (SBE) data on the relationship of assessed to full value for various types of property. Since a number of assumptions were used in the analysis, such as the way in which property tax exemptions were distributed, and since the SBE data itself was based upon an appraisal sample, the figures developed may not be precise, but are undoubtedly correct indicators of the magnitude of the problem

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3. See Chapter II for a discussion of housing market effects including capitalization.

faced by San Francisco. The quantification of the problem itself is a necessary prelude to recommending the size and constituency of any new tax package--and SBE sources appear generally excellent.<sup>4</sup> At the time this report was written, the unsecured roll was undergoing substantial changes; however, the effects of these changes on the size of the assessment problem should be minimal.

### Effects of a Standard Ratio

Reassessment places the City squarely on the horns of an uncomfortable dilemma. If assessment ratios are brought into parity they will upset the traditional and accepted balance between the homeowner and the business community as sources of revenue. But this dilemma cannot be escaped by choosing, say, a 20 percent ratio instead of a 25 percent ratio. Such proposals have been put forth in attempts to mitigate the effects of AB 80, but their proponents have failed to analyze fully the consequences of these recommendations. Of fundamental importance to the whole analysis of AB 80's effects is the fact that when industrial property is assessed at about 25 percent of full cash value, and when at the same time residential property enjoys a 10 percent assessment ratio, the selection and imposition of any standard ratio between 10 and 25 percent will involve the same disequilibrating effects. The reason for this lies in the fact that residential property accounts for one half of the full cash or net market value of the tax roll, but has been assessed at about half the ratio of industrial and commercial property.<sup>5</sup> There is no way to administratively escape this calculus, given fixed revenue requirements; thus the decision to move to the total 25 percent assessment ratio during the coming fiscal year despite an option to delay imposing such a high ratio until 1971-72 cannot seriously be faulted. For the assessor to choose any other fixed ratio would have had effects of approximately the same magnitude. Standardization also means that henceforth the distribution of tax liability will not be a function of assessed value and assessment ratios but of net market value alone.

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4. SBE appraisal samples are such good indicators of the condition of a tax roll that they are regarded as an indispensable reference.

5. Net market value is defined as market value (full cash value) minus appropriate exemptions.

## The Findings

Investigations show that the previous assessment policy resulted in residential property being assessed at about 12.8 percent of full cash value.<sup>6</sup> Moreover, it was common for comparable residential properties to be assessed at significantly different ratios of assessed to full cash value.<sup>7</sup> During fiscal year 1965-66 (roll year 1965) total, locally assessed values (less exemptions) rose to almost \$1.5 billion. (See Table 3.) This total, combined with approximately \$190.6 million in state-assessed property, consisting primarily of utility properties, produced a property tax roll with a total valuation of \$1.7 billion. Of this grand total, the residential component amounted to \$547.8 million or approximately one-third. Land assessments made up about 25 percent of the dollar value of residential property total. For no other type of property could assessment be said to have been more unrepresentative of contemporary market conditions. Fractional assessment ratios for the land component were a mere 6 percent while those on improvements were over 20 percent. The abnormally low rate on land pulled the entire residential classification down to its 12.8 percent average. Indeed, the frequently observed sluggish increase in assessed land values in recent years may be largely attributable to the quality of assessment practices in respect to the valuation of land.

Table 4 shows a distribution of all assessed value by property type, and also provides a basis for deriving the size of changes in the tax burden. When secured and unsecured rolls are combined, residential taxpayers are found to have been responsible for payment of approximately one-third of total City property tax receipts, or \$148.7 million, during fiscal year 1965-66. Commercial taxpayers were found to be the largest taxpayer group. They presently shoulder about 40 percent of the total burden. But what about the distribution of the tax burden after AB 80? Table 5 indicates what the assessment roll will look like after reassessment.

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6. This represents the weighted mean ratio of assessed to full-cash value for residential property. It was not unusual for City residents to have their homes assessed at ratios as low as 9 or 10 percent of full cash value. Commercial and industrial property, on the other hand, has usually been assessed at close to 25 percent, previous assessor's claim to the contrary. Inventories, usually taxed on the unsecured roll, have been assessed at ratios exceeding this fraction.
7. The coefficient of dispersion, the index of assessment inequality, was 28 percent for residential property according to SBE. Most experts in the tax administration field would agree that an index of 10 to 20 percent is an indication of reasonably good administration.

TABLE 3

ESTIMATED DISTRIBUTION OF LOCALLY ASSESSED VALUE BY PROPERTY  
TYPE BEFORE REASSESSMENT<sup>a</sup> FISCAL YEAR 1965-66

<u>Property Type</u>	<u>Amount</u>			
	<u>Land</u>	<u>Improvements</u> (thousands)	<u>Personal Property</u>	<u>Total</u>
Secured roll <sup>b</sup>				
Residential	\$136,341	\$410,339	\$ 1,159	\$547,840
Vacant	357	-	-	357
Commercial	173,845	296,890	2,321	473,056
Industrial	42,418	110,842	-	153,260
Total, Secured roll	352,961	818,072	3,480	1,174,513
Unsecured roll <sup>c</sup>				
Residential	-	-	568	568
Vacant	-	-	-	-
Commercial	-	-	221,444	221,444
Industrial	-	-	98,784	98,784
Total, Unsecured roll	-	-	320,796	320,796
Secured plus un- secured				
Residential	136,341	410,339	1,727	548,407
Vacant	357	-	-	357
Commercial	173,845	296,890	223,765	694,500
Industrial	42,418	110,842	98,784	252,044
Total, secured plus unsecured	352,961	818,071	324,276	1,495,309 <sup>d</sup>

- Net of estimated exemptions determined by allocators based on distribution of gross value and Assessor's data for portion of exemptions allocable between land and improvements.
- Consists of property secured by real estate.
- Consists mainly of improvements on leased land, leasehold improvements, possessory interests and inventories.
- This total may be reconciled with detailed statement appearing in Controller's report by including \$2.6 million in exemptions never included in that total but which appeared in later tabulations by Assessor's office.

Source: Computed from California State Board of Equalization's locally assessed property value sample (unpublished) and City of San Francisco Assessor's office detail on exemptions.

TABLE 4

ESTIMATED DISTRIBUTION OF ASSESSED VALUE BY PROPERTY TYPE<sup>a</sup>  
FISCAL YEAR 1965-66

<u>Property Type</u>	<u>Percent Distribution</u>			
	<u>Land</u>	<u>Improvements</u>	<u>Personal Property</u>	<u>Total</u>
Secured roll				
Residential	8.1	24.3	.1	32.5
Vacant	-	-	-	-
Commercial	10.3	17.6	.1	28.1
Industrial	2.5	6.6	-	9.1
Total, Secured roll	20.9	48.5	.2	69.7
Unsecured roll				
Residential	-	-	-	-
Vacant	-	-	-	-
Commercial	-	-	13.1	13.1
Industrial	-	-	5.9	5.9
Total, un-secured roll	-	-	19.0	19.0
Secured plus unsecured				
Residential	8.01	24.3	.1	32.5
Vacant	-	-	-	-
Commercial	10.3	17.6	13.3	41.2
Industrial	2.5	6.6	5.6	14.9
Total, secured plus unsecured	20.936	48.525	19.235	88.696
State assessed	<u>.948</u>	<u>6.521</u>	<u>3.837</u>	<u>11.306</u>
Grand Total	21.884	55.046	23.071	100.00

a. Net of estimated exemptions determined by allocators based on distribution of gross value and Assessor's data for portion of exemptions allocable between land and improvements.

Source: Computed from Table 3 and additional SBE data on state assessed property.

TABLE 5

ESTIMATED DISTRIBUTION OF ASSESSED VALUE BY PROPERTY  
TYPE AFTER REASSESSMENT<sup>a</sup> FISCAL YEAR 1965-66

<u>Property Type</u>	<u>Amount</u>			<u>Total</u>
	<u>Land</u>	<u>Improvements</u> (thousands)	<u>Personal</u> <u>Property</u>	
Secured roll				
Residential	\$568,542	\$508,820	\$ 1,089	\$1,078,451
Vacant	1,396	-	-	1,396
Commercial	243,383	216,730	2,483	462,596
Industrial	63,203	97,540	-	160,743
Total, secured roll <sup>b</sup>	876,524	823,090	3,572	1,703,186
Unsecured roll				
Residential	-	-	841	841
Vacant	-	-	-	-
Commercial	-	-	183,799	183,799
Industrial	-	-	83,966	83,966
Total, un- secured roll <sup>b</sup>	-	-	268,606	268,606
Total, secured plus unsecured	876,524	823,090	272,178	1,971,792
State assessed	<u>15,989</u>	<u>109,944</u>	<u>64,682</u>	<u>190,615</u>
Grand Total	\$892,513	\$933,034	\$336,860	\$2,162,407

a. Assumes 1965 roll year valuations were at 25 percent of full cash value.  
Amounts one net of exemptions.

b. Totals by addition of detail.

Source: Computed from Table 3 and SBE data.



Although locally assessed ratables (assessed valuation) will be substantially increased through the 25 percent reassessment ratio (from \$1.5 billion to almost \$2 billion), most of this increase in value will occur within the residential category. Residential ratables will be almost doubled, but the locally-assessed total will increase by only a third. Moreover, unsecured assessment could actually shrink from about \$320.8 million to \$268.6, a 20 percent net reduction for this type of roll. The overall design of the adjusted property tax base is shown in Table 6. Tables 3 and 5 show a before and after relationship. The distributions differ so strikingly that it would be possible to conclude that we are describing tax bases for two different cities rather than for the same city at two points in time.

The crucial question for the City's taxpayers, however, hinges on whether additions to the tax rolls under a 25 percent standard ratio will be so great that the rate will fall precipitously enough to result in only modest increases in the tax bills of residential property owners. Unfortunately for the residential taxpayer, the answer must be, no. By elaborating on our before and after relationships established in Tables 3 and 5, we can easily demonstrate what the tax rates would have been for 1965-66, assuming the 25 percent ratio became effective during that period. In order to raise the same revenues, \$168.4 million, the tax rate would have declined from \$10.17 to \$7.58 per \$100, a decline of \$2.59. (See Table 7.) This decline would not offset the increased tax vulnerability of residential property due to higher assessments. If the \$7.58 rate were to be applied to residential assessed values, total collections from this category would have been \$81.7 million, or an increase of \$26.0 million over the actual figure, \$55.7 million. This contrasts with a net reduction in the tax liability of \$22 million for owners of commercial and industrial properties.

The drastic effects of a standardized ratio may be illustrated a second way. If the question is asked: how low would the new tax rate (after equalization) have to be in order to extract the same amount of revenue from the residential-property taxpayer as did the old rate before equalization? The answer is that the tax rate would have to be halved. The residential tax base was formerly valued at \$547.8 million, was subject to a \$10 rate, and contributed \$55.7 million to the City. Because the residential base has been revalued at \$1.1 billion, the City would need only impose a \$5.165 rate to produce the same yield, \$55.7 million. This alternative is hardly acceptable since commercial and industrial real estate would be paying about half the taxes previously levied. Commercial and industrial real estate assessments would shrink from \$947 million to about \$891 million and would yield \$31.5 million less in taxes as a result of a \$5 levy. Once again, a recurring theme of this inquiry is heard, that is, that the City, under AB 80, cannot escape redistribution of the property tax burden from commercial-industrial to residential property owners.

TABLE 6

PERCENT DISTRIBUTION OF ASSESSED VALUE BY PROPERTY TYPE  
AFTER REASSESSMENT FISCAL YEAR 1965-66

<u>Property Type</u>	<u>Percent Distribution</u>			
	<u>Land</u>	<u>Improvements</u>	<u>Personal Property</u>	<u>Total</u>
Secured roll				
Residential	26.29	23.53	.05	49.87
Vacant	.06	-	-	.06
Commercial	11.26	10.02	.11	21.39
Industrial	2.92	4.51	-	7.43
Total, secured roll	40.53	38.06	.16	78.75
Unsecured roll				
Residential	-	-	.04	.04
Vacant	-	-	-	-
Commercial	-	-	8.50	8.50
Industrial	-	-	3.88	3.88
Total, un- secured roll	-	-	12.42	12.42
State assessed	<u>.74</u>	<u>5.08</u>	<u>2.99</u>	<u>8.81</u>
Grand Total	41.27	43.14	15.57	100.00

Source: Computed from Table 5.

TABLE 7

ESTIMATED PROPERTY TAX RATES BEFORE AND AFTER REASSESSMENT  
AS REQUIRED UNDER AB 80<sup>a</sup> FOR FISCAL YEAR 1965-66

<u>Consolidated Tax Roll</u>	<u>Tax Base</u> <sup>b</sup> (thousands)	<u>Yield</u> <sup>c</sup> (thousands)	<u>Rate</u> (per \$100)
Before Reassessment			
Total secured	\$1,365,128	\$138,806	\$10.168
Unsecured	320,796	29,610	9.230 <sup>d</sup>
Solvent credits	(701,108)	701	.100
Total	1,685,924	169,117	-
After Reassessment			
Total secured	1,893,801	143,624	7.580 <sup>e</sup>
Unsecured (local)	268,606	24,792	9.230 <sup>d</sup>
Solvent credits	(701,108)	701	.100
Total	2,162,407	169,117	.100

- a. Table assumes 1965 roll was reassessed in conformance with AB 80's 25 percent of full value requirement; base not strictly comparable with published data due to differences in treatment of exemptions.
- b. Base computed from California State Board of Equalization data on assessed values: see Tables 3 through 6.
- c. Yields not strictly comparable with actual total collections (\$165,214) due to: (1) slight differences in base as noted above and (2) revenues fall short of levies for various reasons, including delinquencies.
- d. Previous year's rate applies to unsecured roll.
- e. Computed by dividing revenues by tax base.

Source: Computed from Tables 3 through 6.

To illustrate this problem from a third vantage point, a hypothetical homeowner with a house appraised at \$30,000 and assessed at \$3,840 paid \$390 in property taxes in fiscal year 1966. If his home had been reassessed at the 25 percent ratio, he would have paid \$568 in taxes on his assessed valuation of \$7,500, an increase of \$178 or 46 percent. If he had lived in a home which had a lower assessment ratio of say 9 or 10 percent, his plight would have been that much more difficult--he might have had to pay twice as much in taxes after reassessment (Chapter II examines this phenomenon in greater detail.)

Either way, from the homeowner's viewpoint or from that of the entire residential taxpaying "class," tax bills are bound to increase with reassessment.

### Present Outlook

Not only will homeowners have to bear much of the burden of the previously cited \$26 million shift within the City's tax system, but they will also be called upon to pay a larger share of new tax increased than ever before. The City is about to begin spending a record \$433 million budget. The revenues needed to underwrite the budget will be raised largely through the property tax. According to the proposed property tax requirement estimate shown in Table 8, San Francisco will need \$197.5 million in property tax revenue for 1967-68. This represents an increase of \$18.2 million over the anticipated yield for the fiscal year ending June 30, 1967. Considered alone, this amount stands as the largest property tax increase for San Franciscans in recent years.

It is understood that of the \$18.2 million increase, homeowners will pay approximately 49.9 percent or \$9.1 million. This, combined with "the shift" creates a one-year increase of over \$35 million on residential property alone. However, the net shift for this coming year is \$29 million for residential property owners. For comparison purposes, one should not lose sight of the fact that if reassessment had not been imposed on San Francisco, homeowners would have had to pay only about one-third of the \$18.2 million increase (\$6.0 million) or about two-thirds of what they will be paying (\$9.1 million), solely as a result of increased expenditures. The point, of course, is that San Franciscans should recognize that not only does reassessment mean higher burdens for homeowners during the present round of reassessment, but it also means that homeowners will be paying a larger share of future tax burdens as well.

For purposes of further illustration, we will take the case of a hypothetical homeowner with a house worth \$40,000. On the basis of the independent analyses of both revenue requirements and the tax base which have already been presented in this chapter, a rate of about \$8.88 per hundred dollars of assessed

TABLE 8

SUMMARY OF ESTIMATED SAN FRANCISCO TAX REQUIREMENTS  
FISCAL YEAR 1967-68

<u>Item</u>	<u>Amount</u> (thousands)
Proposed property tax requirements, all functions	\$202,225.7 <sup>a</sup>
Less the following modifications:	
Unspent appropriations (surplus)	\$4,000.0
Miscellaneous increase in various revenue estimates	1,000.0 <sup>b</sup>
Increase in sales tax revenue estimates	1,000.0 <sup>b</sup>
Unspent unappropriated and emergency reserves	500.0
Use of salary saving	800.0
Reductions due to Board of Super- visors' recommendations	2,500.0 <sup>c</sup>
Subtotal, reductions	9,800.0
Plus the following modifications:	
Emergency reserve replenishment	1,500.0
Cash reserve replenishment	1,800.0
Mayor's supplemental request	1,800.0
Subtotal, increases	<u>5,100.0</u>
Adjusted property tax requirements	\$197,525.7

- a. Amount derived from consolidated budget summary in proposed appropriation ordinance as published by the San Francisco Examiner (\$128,203,282), plus estimated amounts for other functions including schools
- b. Revenue estimating in San Francisco is traditionally conservative; by making more realistic estimates of other revenues, the property tax requirement may be lessened.
- c. Although the Board recommended a \$4,000,000 cut in appropriations, only about \$2,500,000 will show up in property tax reductions.

value appears likely.<sup>8</sup> This house was previously assessed at 8 percent of its sales value, as were many under the old rate, and the owner was paying \$382. With the new rate and new assessment ratio he will be paying \$888, an increase of more than \$500 or 132 percent. (It is quite easy to play this game with any piece of real estate; all one needs is his present property's assessment ratio and last year's tax rate.) It remains for the next chapters' research to measure the impact on various types of residential property.

Full correction of property assessment ratios will do more than drastically alter the City's property tax base. The additional \$29 million in taxes which owners of residential property will have to pay as a result of AB 80 will place the costs of running San Francisco more squarely on the City's residents than every before. At the same time, the business community will receive a windfall of approximately the equivalent amount. This will hold true despite any change in rate. For it is obvious that the tax burden would have been higher for business if AB 80 had never been implemented. The reason that the shift is of importance to San Francisco is that the old de facto classified property tax structure which discriminated among types of property did so because it served community objectives.<sup>9</sup> In effect, the business community was taxed at a fixed special rate which existed in lieu of other types of major local business taxes. Because of this, the City must now ask itself; do we want to, should we, and can we, seek some alternative revenue measure which, from the aggregate tax standpoint, will partially mitigate the effects of reassessment on the relative tax shares now made by resident homeowners, tenants, and business enterprises? Before an attempt is made to answer this question, however, consideration must be given to the actual effects of reassessment on the housing stock. (See the following chapter.)

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8. This figure must not be interpreted to mean that the rate will actually be \$8.88. It would be only coincidental if it were since certain funds and reserves may be tapped in ways unfamiliar to anyone but a full-time City employee. The unknown final size of the unsecured roll constitutes another cause for adjustment of the rate. Also, at the time this is being written, further minor changes to the proposed budget may be made. Finally, the revenue estimates themselves may be changed thereby changing property tax requirements which are really in the nature of a fiscal residual. However, the figure stands as an independently-arrived-at estimate which reflects the correct order of magnitude of the eventual rate.

9. See Chapter III for a discussion of this observation.

## Property Tax Relief

The relentless rise in the property tax burden has caused homeowners to believe that Sacramento will respond to their plight and appropriate enough funds in the form of property tax relief to soften the full impact of reassessment. Ordinarily, property tax relief has something of a narcotic effect on taxpayers, leading them to believe that their total tax burdens will really be lower, all evidence to the contrary. This year, not only is there no question that property tax relief would be welcomed by homeowners, but there is also good reason to believe that if administered in large enough doses it could buoy up the housing market for single-family homes.<sup>10</sup>

This latter point may be seen as a collective goal of San Franciscans in general, although there is a good argument relative to regional development that asserts that the changing role of the central City precludes encouragement of small homeowners.<sup>11</sup> But whether property tax relief is good or bad for San Francisco is not piercingly relevant, since it has already been decided that San Francisco homeowners will not be the recipients of special funds specifically aimed at cushioning the impact of AB 80. The two revenue proposals which do mention property tax relief will not mean very much to San Francisco even if enacted.

Governor Reagan has suggested that direct property relief be effected by means of a credit against the school tax levy.<sup>12</sup> Funds would be allocated to local collectors to reimburse them for the amount of the credit. Under Governor Reagan's plan, aid will be extended to all taxpayers, not merely homeowners, and will be done so on the basis of a formula allowing a tax credit of 3 cents on a school levy of at least \$2.00 but not more than \$2.20; 5-1/2 cents on \$2.20 to \$2.40; and a graduated increase to 60 cents on tax rates above \$6.00 per \$100 of assessed valuation. Assuming San Francisco's school tax levy were approximately \$2.80 as a result of reassessment, San Francisco would be eligible to receive approximately half a million dollars in new revenue. This is only a small step toward the relief really needed. Furthermore, because the Reagan proposal also allows businessmen to avail themselves of the credit, an additional windfall will develop for commercial and industrial landlords. In summary, the

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10. Chapter II discusses the downward pressure which reassessment will cause for this part of the housing stock.

11. It may be argued that reassessment, by increasing tax bills and lowering property values, will be a catalyst for the transformation of single-family dwellings, the ones most affected by reassessment, to higher intensity land uses. Some would contend that this goal takes precedence over the retention of families now residing in them.

12. State of California, Tax Message of Ronald Reagan, Governor of California, March 8, 1967.

Reagan proposal may or may not have some intrinsic merit, but it hardly focuses on San Francisco's current problem.

The other property tax relief proposal, the Veneman bill, calls for property tax assistance for elderly persons of limited means.<sup>13</sup> Under this proposal the State Franchise Tax Board would, commencing in 1968, make payments to those eligible in accordance with a formula based on household income and the amount of tax paid on a homestead's first \$5,000 of assessed value. Although it was not feasible to estimate the effect of this bill on the effective tax rate paid by all elderly people in the City, the following scale indicates what effects it would have on elderly people in the following situations:

<u>Household Income</u>	<u>Percent Property Tax Relief on First \$5,000 of Value<sup>a</sup></u>	<u>Percent Property Tax Relief on a \$30,000 Home<sup>b</sup></u>
\$1,000	95	47.5
2,500	35	17.5
3,000	15	7.5
3,350	1	.5

- a. Equivalent to a \$20,000 home (market value) with reassessment.  
b. Market value.

It is certainly apparent that this proposal would provide the retired and elderly homeowner living in San Francisco with a large measure of tax relief if he had a low income. Unlike the Reagan proposal, this bill would directly affect those San Franciscans who will need relief most; the virtually immobile widows and elderly couples who are barely holding on to their homes. Nevertheless, this bill is restricted to the elderly, and therefore will not provide the average San Franciscan with any direct relief.<sup>14</sup> San Franciscans will have to look to other alternatives for a means of relieving their tax discomfort.

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13. California Legislature, 67 Session, Assembly Bill No. 484, 485, 486.

14. According to John G. Veneman, Chairman of the Assembly Committee on Revenue and Taxation, San Francisco will receive no new money for property tax relief under AB 484-5-6. This is so even though AB 484 appropriates \$320 million in additional revenue into the state school fund for 1968-69 for reduction in school property tax rates, because the funds will be allocated on the equalization aid concept. San Francisco has a "wealthy property base" according to the standards now in use and receives no equalization. See AB 484-5-6 "Explanation and Analysis," Appendix A.



## CHAPTER II

### THE IMPACT OF REASSESSMENT ON SAN FRANCISCO RESIDENTS

People's choices of residential location will be influenced by changes in the property tax burden, since it is clear that reassessment of property will alter tax burdens currently borne by many San Francisco families. This chapter provides an empirical basis for estimating the impact of AB 80 reassessment on City families and for forecasting the probable effects of the tax change on their locational choices. The analysis proceeds along two lines: the first measures changes in rents and house values which may be caused by the tax; the second makes inquiry into inter-county differences in taxation within the Bay Area. Taken together, the meaning of reassessment to San Francisco households becomes evident.

#### DIRECT IMPACT OF REASSESSMENT ON SAN FRANCISCO FAMILIES AND HOUSING STOCK

##### Approach

The San Francisco housing stock may be divided into several types of dwelling units. The impact of reassessment will be uneven among these dwelling types, and since different groups of people live within the various types of dwellings, reassessment will consequently have uneven effects on these several groups. Arthur D. Little, Inc., has linked Census dwelling types with population characteristics. By determining the effects of reassessment on dwelling units, the impact can also be measured on those population groups which live in such dwelling units.<sup>1</sup> This is an oversimplification of the impact analysis presented in this chapter. Nevertheless, it illustrates the kind of approach used herein.<sup>2</sup>

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1. To aid in measuring the impact of change in effective tax rates resulting from reassessment, the City's 1960 housing stock was broken down into nine categories by using data from the 1960 Census of Housing. The City's 1960 population was also broken down into subgroups and matched with the kind of dwelling units they inhabited.
  2. One word of caution in interpreting the results offered. So-called statistical averages are not real-types. Few actual people or dwelling units may be affected exactly as indicated in the impact study. One must keep this limitation in mind if an attempt is made to apply the findings of this study to a particular situation with which the reader is familiar.

## A Review of the Types of Effects to be Expected from Tax Increases

The change in tax assessments will have two major effects. It will alter shelter costs of some households, and/or it will change the market value of some dwelling units. The initial analytical approach taken was to estimate separately the possible effect on different household groups if the full impact of the tax were to be reflected by a direct increase in housing costs (i.e., complete forward shifting of the tax increases to "consumers" of housing). Another set of estimates was then developed under the assumption that the full impact of the tax will be reflected in changes in the market value of some dwelling units, i.e., the burden of the tax will be capitalized. (Actually, the effect of the tax may be expected to comprise both eventualities so long as the tax is not shifted backward to all factors of production in a diffused manner.)

Consider as an example of complete forward shifting the results that could follow a tax increase of, say, 48 percent. A nonresident landlord might attempt to pass on the tax increase of 48 percent by raising rents an equivalent amount. If we assume the tax moved from \$1,000 per year to \$1,480 per year, and he has 4 rented units, he might then ask his tenants to pay \$120 more per year. That is, the rent of each unit would be raised by \$10 per month in order to cover the full amount of the tax. If he is successful, then housing costs would go up by the full amount of the added tax, and no change in market value would be induced since the landlord's rate of return on his investment would remain constant.

If, however, the landlord finds that tenants are completely resistant to any rent increases and are willing and able to move elsewhere if rents are raised, then the value of the property will change because the value of any property is related, although imperfectly, to the income it generates (or housing satisfaction derived for owners of occupied units). Thus, a tax increase of \$480 that is not offset by any rent increases would reduce the income stream by the amount of the tax. The relationship between the income stream and value is called a capitalization ratio and differs among various types of structures.<sup>3</sup>

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3. Arthur D. Little, Inc., has made a study of these relationships which is discussed in Appendix A. To illustrate this process, the average capitalization ratio typical of structures with 2-4 dwelling units is 8.5 percent. That is, the income stream divided by the market value— $\frac{(\text{income from rentals})}{(\text{market value})}$ —is 8.5 percent. In this case, a reduction in the rental income stream of \$480 would result in a drop in market value of \$5,647. If we let X equal the drop in market value, then we can arrive at this amount by solving the following equation:  $\frac{-480}{(X)} = .085$ , or  $(X) \times .085 = -480$ , and  $(X) = \frac{-480}{.085} = \$5,647$ . Thus, in our example the increase in the property tax of \$480 would result in a drop in value of \$5,647 if the full impact of the tax were reflected on market value.

In all cases, of course, the actual ability of landlords to shift large portions of the tax forward to renters will depend on the consistency of demand for housing in San Francisco. This, in turn, is linked to a constellation of factors related to city living and in particular the services provided by the City. For instance, if the City's public school system were to decrease in quality (families with children are already less desirous of living in San Francisco) a rent increase might serve as a catalyst, so reducing the attractiveness of their present location that they would move out of San Francisco and consequently lower the intensity of demand. By the same token, an increase in the quality of the school system, perhaps occasioned by the spending of the funds the City picked up from a tax rate increase, might completely offset the tax effect and would serve to increase the demand for housing, thereby facilitating higher rentals.

### Some Definitions

Actual housing costs for owner-occupants consist of interests on home mortgages, maintenance, repairs, house-related insurance, property taxes, utilities, and depreciation. Unfortunately, we have no data comparable to the Census classification that would indicate what these expenses actually were in recent years for San Francisco homeowners. Instead, the 1960 Census tabulations, originally utilized in research on the San Francisco Community Renewal Program, contain estimates of the value of owner units as well as rental estimates for tenant-occupied units. The information on the value of owner-occupied units was used to calculate an implicit or imputed rent for owner occupants in the various household groups that analytically would be roughly comparable to the gross rent data that is available for tenant households.

The concept of "implicit" or "imputed" rent for owner-occupant households refers here to the income that would normally flow from a property if it were rented on the market instead of being utilized by the owners in the form of housing satisfaction, which is a noncash form of income. The implicit rents that have been calculated as applying to owner-occupants do not reflect the actual cash expenditure, but are merely a surrogate for this amount. Stated another way, these surrogates represent rent costs implicitly but not actually borne by households because they elect to live in a dwelling unit instead of renting it and taking the income from their investment.

The use of implicit rent estimates permits a single calculation of implicit and actual (explicit) rents for combined groupings of both tenants and owner-occupant subgroups with equivalent demographic and economic attributes. A comparison of this rental figure with the average household income of each group permits an approximation of the percentage of its cash income that each group spends on housing. Thus rents are regarded as a proxy value for shelter expenses throughout this study. Census data for 1960 was utilized to make these approximations and to simulate the impact of the standardization of assessment ratios dictated by AB 80.

### An Illustrative Example of the Tax Impact Analysis

Before moving directly to the findings, which are presented in Table 9, we will first take the example of a retired couple living in their own home having between one and four rooms and valued at \$12,000 (assessed value of \$1,200). The current tax for this structure would thus be assessed value multiplied by the present tax rate of \$10.61 per \$100 of value, or \$127.32. This figure is placed in column 1 of the illustrative table appearing below, which portrays the types of findings and classifications employed in this analysis and shown in Table 9. By applying a capitalization rate of, say, .075, an implicit rent of \$900 (i.e., .075 x \$12,000 per year) may be computed. This amount, indicated in column 2, is equivalent to 30 percent of the household's \$3,000 income. Another set of calculations shows the after-tax effect. By substituting the imminent 25 percent assessment ratio together with a new tax rate of \$8.90 per \$100, the couple's new tax will be \$267.00. (See column 3 below.)

The total tax to be paid by this couple has increased by 101 percent, as indicated in column 4 of the illustrative table. The addition of the \$140 tax increase to the implicit rent would bring the estimated total of rent plus tax to \$1,040, or 35 percent of the household's total income as posted in column 5. By comparing the couple's rent-to-income percentage before and after the property tax increase, it is possible to determine how much greater a percentage of their total income they must pay for shelter as a result of the tax increase.

#### EXAMPLE OF ANALYSIS AS APPLIED TO HYPOTHETICAL SINGLE RETIRED COUPLE WITH \$4,000 CASH INCOME

(1)	(2)	(3)	(4)	(5)	(6)
Estimated Taxes Paid Prior to AB 80	Estimated Per- cent Implicit Rent to Income Paid Now	Estimated New Tax	Percent Increase in Tax	Percent Im- plicit Rent to Income After Tax	Increase in Percent of Rent Plus New Tax to Income (Col 5-Col
\$127	30%	\$267	101%	35%	5%

For the hypothetical couple this implicit rent-to-income percentage has gone up from 30 percent to 35 percent, and the 5 percent increase noted in column 6 provides an indication of the relative effect of the change induced by AB 80 if the household absorbs the full impact of the tax out of its income. This example is typical of the analysis undertaken for all of the San Francisco population divided into 15 household subgroups.

ESTIMATE OF MAXIMUM POSSIBLE TAX EFFECT ON SAN FRANCISCO HOUSEHOLDS<sup>a</sup>

1	2	3	4	5	6	7	8	9	10	11	12
	Household	Number of	Estimated Taxes	Estimated Percent	Estimated New	Percent	Pent of Implicit	Increase in	Significant Structural Types Inhabited by		
Designation	Attributes	Dwelling Units in Which These Householders Live	Paid on Dwelling Units Prior to AB 80 (thousands)	of Implicit and Explicit Actual Rents to Income Paid Now	Tax on Relevant Dwelling Units (thousands)	Increase in Tax	and Implicit Rent to Income Paid if all NTax is Passed to Residents	Percent of Rent to Income After New Tax	Percent of Householders	Type	Condition
1	White; no children; income under \$4,000	74,905	\$10,667	43.5	\$14,629	37.1	46.4	2.9	16.24 14.77 12.65 12.26 9.15 6.69 6.58	7 6 8 2 4 6 1	2 3 2 2 2 2 2
2	White; no children; income between \$4,000-\$8,000	64,919	943	18.5	1,413	49.8	20.1	1.6	19.59 18.50 15.34 11.74 8.79 7.55	8 2 7 4 1 5	2 2 2 2 2 2
3	White; no children; income over \$8,000	47,890	11,004	10.7	17,617	60.0	11.8	1.1	30.51 18.14 12.49 8.95 8.79	2 8 5 3 4	2 2 2 2 2
4	White; adults with children; income under \$4,000	9,893	1,591	41.9	2,510	57.8	46.0	4.0	18.67 17.17 15.53 10.80 10.78 4.48	2 8 4 5 1 4	2 2 2 2 2 3
5	White; adults with children; income between \$4,000-\$10,000	38,719	6,784	17.6	12,207	79.9	18.6	2.1	39.49 16.35 9.96 8.86 7.64	2 5 1 4 3	2 2 2 2 2
6	White; adults with children; income over \$10,000	15,350	3,667	10.6	7,068	92.7	12.0	1.5	41.34 28.81 13.73	2 3 5	2 2 2
7	Oriental and Other; no children; income under \$4,000	8,135	801	19.6	985	23.0	20.5	.8	27.67 16.16 10.87 8.41 6.62 3.79 3.55	6 6 8 7 4 5 7	3 4 2 2 2 2 3
8	Oriental and Other; no children; income over \$4,000*	2,744	444	9.4	647	45.7	10.1	.8	17.82 17.06 12.92 12.07 6.14 4.86 4.74	8 5 4 2 9 1 7	2 2 2 2 2 2 2

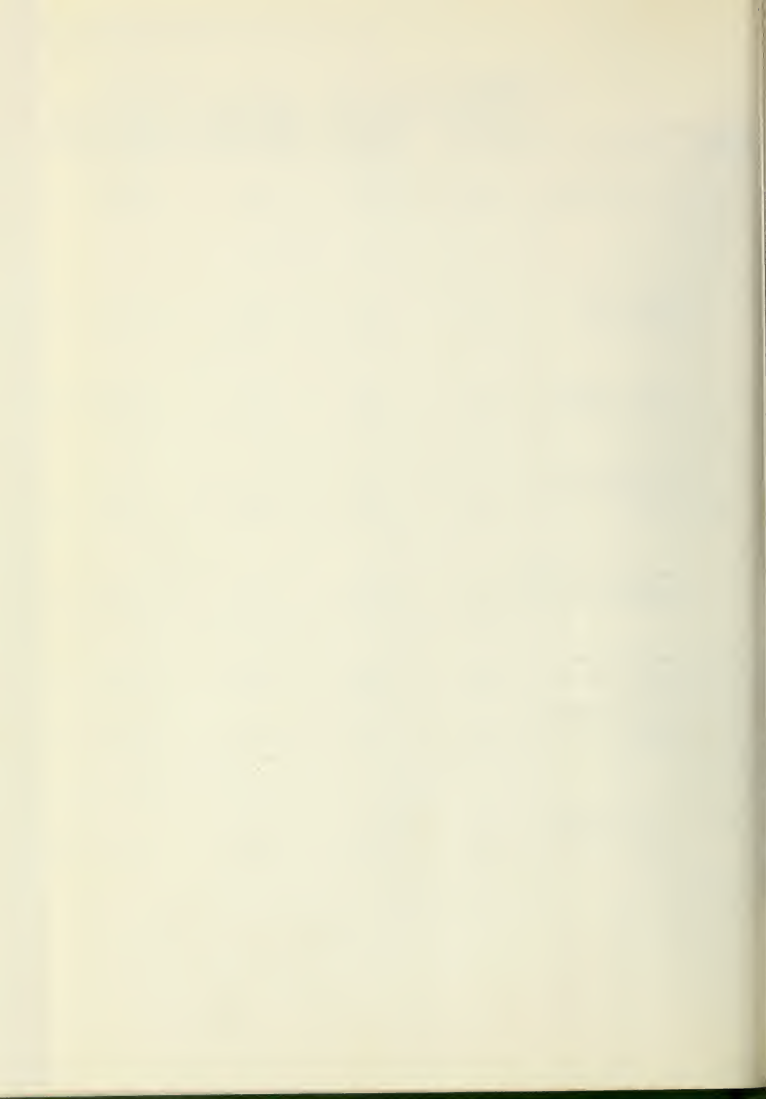


TABLE 9 (Continued)

1	2	3	4	5	6	7	8	9	10	11	12
Household		Number of	Estimated Taxes	Estimated Percent	Estimated New	Percent	Percent of Implicit	Increase in	Significant Structural Types Inhabited by		
Designation	Attributes	Dwelling Units in Which These Householders Live	Paid on Dwelling Units Prior to AB 80 (thousands)	of Implicit and Ex- plicit Actual Rents to Income Paid Now	Tax on Relevant Dwelling Units (thousands)	Increase in Tax	and Explicit Rent to Income Paid if all New Tax is Passed On to Residents	Percent of Rent to Income After New Tax	Percent of Householders	Type	Condition
9	Oriental and other; adults with children; income under \$6,000	2,092	\$12	32.1	\$25	08.3	37.1	5.0	29.70	8	2
									14.52	4	2
									10.93	5	2
									8.66	9	2
									6.32	2	2
									4.91	1	2
10	Oriental and other; adults with children; income over \$6,000	6,946	1,170	12.3	1,857	58.7	13.5	1.2	22.54	5	2
									19.07	2	2
									15.62	8	2
									9.72	4	2
									8.63	3	2
11	Negro; no children; 1-person households, 2-person households with income under \$4,000; 3 or more person house- holds with income under \$6,000	9,101	1,132	22.0	1,535	35.6	23.5	1.4	17.25	8	2
									12.82	4	2
									7.91	6	4
									7.71	4	3
									7.28	5	2
									7.15	6	3
									5.80	7	2
									5.79	2	2
									4.89	1	2
12	Negro; no children; 2-person households with income over \$4,000; 3 or more person house- holds with income over \$6,000	2,493	397	10.2	642	61.7	11.3	1.0	24.43	2	2
									16.19	4	2
									14.52	5	2
									12.49	8	2
									8.04	1	2
13	Negro; adults with children; income under \$4,000	1,402	185	96.8	252	36.2	103.1	6.3	28.45	8	2
									11.11	9	2
									9.06	4	3
									7.57	2	2
									7.18	5	2
									6.20	4	2
									5.77	1	2
14	Negro; adults with children; income be- tween \$4,000-\$8,000	5,035	723	20.0	1,050	45.2	21.6	1.6	23.03	8	2
									13.68	2	2
									12.57	9	2
									9.39	5	2
									8.36	4	2
									5.53	1	2
15	Negro; adults with children; income over \$8,000	3,522	560	11.3	957	70.9	12.6	1.3	31.32	2	2
									15.53	5	2
									10.33	8	2
									7.46	3	2
									6.81	4	2
									5.77	1	2

a. Assumes taxes will be paid out of current family income.

\* These figures were taken from the Census of Housing and will not be directly comparable with the figures in Appendix B, Tables 1-6, which were taken from the Census of Population.

Source: Computed from U. S. Census of Housing data.





### Presentation of the Findings

A listing of the types of dwelling units inhabited by significant percentages of each household group is presented in columns 10, 11 and 12 of Table 9. The numerical references to housing types in column 11 refer to the following:

#### STRUCTURAL CATEGORIES

<u>Housing Type</u>	<u>Structure</u>	<u>Number of Rooms</u>
1	Single Family	1-4
2	Single Family	5-6
3	Single Family	7+
4	2-4 Units	1-4
5	2-4 Units	5+
6	5+ Units	1
7	5+ Units	2
8	5+ Units	3-4
9	5+ Units	5+

The three condition designations that were used in column 12 of Table 9 refer to the housing conditions defined by the Bureau of the Census. Condition 2 includes housing that has been defined as "standard" with full plumbing facilities; condition 3 corresponds to the Census terms "deteriorating" or "standard with plumbing lacking"; and condition 4 indicates "dilapidated" dwellings.

### Effects on Households

Table 9 indicates that three household groups will be burdened by tax increases of greater than 75 percent: white adults with children and incomes between \$4,000 and \$10,000 (group 5); white adults with children and incomes over \$10,000 (group 6); and oriental adults with children and incomes under \$6,000 (group 9). The majority of the first two groups live in single-family houses, and this explains the heavy tax impact since these dwelling units were notoriously underassessed. However, when the tax increases are taken as a proportion of income, these families will experience a smaller change in tax burden--only an additional 1.5 percent increase for group 6, and 2.1 percent for group 5. Group 5 will be paying the higher total-rent-to-income percentage of

18.6, and group 6 will be paying 12.0 percent. The increase will hit group 9 much harder in terms of their income, with an almost 5 percent rent jump if they absorb the full impact of the tax. However, it is important to recognize that only a relatively small proportion of group 9 live in single-family houses, therefore, many will be renters, but often living in structures of less than five units.

All of the groups with incomes of less than \$4,000 (1, 4, 7, 11 and 13) show relatively higher percentages of rent to income, which is not surprising since shelter is a necessity and the demand for it is characteristically income-inelastic. Groups 7 and 11 spend less for rent in relation to their income than the other low-income households, probably because they have no children, and a high proportion of these two groups live in low-quality, small apartments in large apartment houses. They, too, will be relatively unaffected by the tax increase.

Whites without children (group 1, the largest single group) will face a cost rise of close to 3 percent of their income. This group, incidentally, includes a high proportion of older people on fixed incomes. White, low-income households with children (group 4) would have to pay an additional 4 percent of their income if they shoulder all of the burden of added taxes. Approximately 30 percent of this group live in single-family houses.

Table 9 also shows that 1,402 low-income households with children (group 13) would surrender 6.3 percent of their income if they paid all of the added taxes. The implications of this figure are clouded by the possibility that the extremely high rent-to-income percentage is caused by under-reporting of welfare and other cash transfer payments. Only about 13 percent of this group live in single-family houses. This implies that many of them are renters who, since their incomes are already stretched, will not be able to pay higher rents. The remaining groups will all be affected by increased tax charges equaling less than two percent of their 1960 incomes.

The problem may be approached from a completely aggregate standpoint. The 1961 Census of Housing indicated that the City of San Francisco had a total of 293,624 housing units.<sup>4</sup> The research conducted to construct Table 9 estimated the market value of all residential real property to have been \$3.5 billion in 1960. Total income of San Francisco residents was \$1.9 billion. Calculation of rents actually paid, added to imputed rents for owner-occupied dwelling units, yields an estimate of the City's total implicit and explicit rents of \$302 million. Thus, the average San Franciscan's implicit (imputed) and explicit (actual) rental payments amounted to 16.21 percent of his income.

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4. Since that time approximately 3,666 units have been demolished while 21,275 new units have been constructed.

Again, considering the City as a whole and utilizing the assessment ratios of 10 percent for single-family units, 14 percent for dwellings with 2-4 units, and 20 percent for larger apartment houses in conjunction with a tax rate of \$10.61, the total tax levied would have been \$50 million on the total residential market value indicated previously. If all assessment rates are set at 25 percent of value (the AB 80 requirement) and the tax rate drops to \$8.90 per thousand, the total tax receipts of the City would be approximately \$79 million, or a tax increase from residential property of 58 percent.

If a tax increase of this size materialized, and all renters increased their payments to landlords by an amount equal to the tax and therefore values of owner-occupied units were not changed as a result of the tax increase, then the residents' explicit and implicit rent equivalents would rise from 16.2 percent to 17.7 percent of income. While some owner-occupant households will find themselves paying tax increases that represent substantial claims on their incomes, and while some tenants will be asked to pay sizable rental increases, most households will not be as dramatically affected. This conclusion is buttressed by the fact that average real incomes in the United States have increased annually over the past years by an amount greater than the maximum average impact of the tax. Further, Federal income tax offsets will also serve to reduce the worst side-effects of increased tax payments. However, before discussing this further, it is important to present the results of estimates that assume the full impact of AB 80 will fall on value rather than on shelter expenses.

#### Effects on the Market Value of the Housing Stock

Table 10 describes the effect that the implementation of AB 80 would have if its full impact were reflected only in changing the market value of property. The structures that made up 85 percent of the City's housing stock in 1960 were treated separately, and then a single calculation was made for the total City and recorded in the bottom line of Table 10.

The following capitalization ratios were used to compute the changes in value shown in Table 10:<sup>5</sup>

Single-family dwelling units	7.5%
Structures with 2-4 dwelling units	8.5
Structures with 5+ dwelling units	10.5

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5. See Appendix A for a discussion of the origin of these rates.

TABLE 10

ESTIMATE OF EFFECT OF TAX ON VALUE OF DIFFERING STRUCTURE TYPES <sup>assuming tax is apportioned</sup>

Designation	Structural Type Description	Percent of City's Stock	Estimate of Tax Prior to AB 80 (thousands)	Estimate of New Tax (thousands)	Increase in Tax (thousands)	Drop in Value if Fully Reflected of Tax (millions)	Drop in Value as Percent of Old Value
2	Single-family unit with 5-6 rooms	21.9	\$11,858	\$24,868	\$13,010	\$173.47	15.5
8	5 or more unit structure with 3-4 rooms	14.6	9,012	9,449	437	4.16	1.0
5	2-4 unit structure with 5 rooms or more	9.9	5,546	8,308	2,762	34.53	9.2
4	2-4 unit structure with 4 rooms or less	9.7	4,343	6,505	2,262	28.28	9.7
7	5 or more unit structure with 2 rooms	9.0	4,414	4,628	214	2.04	1.0
1	Single-family unit with 4 rooms or less	7.4	3,010	6,313	3,303	44.04	15.5
6	5 or more unit structure with only 1 room	6.0	1,547	1,622	75	.72	1.0
3	Single-family structure with 7 or more rooms	5.5	4,257	8,926	4,669	62.25	15.5
Total listed		84.0	\$43,987	\$70,619	\$26,732	\$329.5	9.0
Total City		100.0	\$50,915	\$78,966	\$28,051	\$350.6	9.9

There is considerable reason to believe that tax capitalization exists in the Bay Area. Older dwelling units in San Francisco are currently more expensive than comparable units outside the City. This may be partially explained by lower effective residential property taxes. Site value, and in some cases higher construction costs, also tend to make residential units of equivalent size and quality more valuable in the City. No empirical research has been undertaken in the Bay Area to determine the extent of the capitalization of property taxes.

Table 10 dramatically illustrates the heavy impact of the tax on single-family houses. The total tax increase for all dwelling types is approximately \$28 million.<sup>6</sup> Approximately \$21 million, or 75 percent of this amount, will be derived from the single-family units designated as types 1, 2 and 3. The maximum value drops that could result from the added impost, when looking at the problem in the aggregate, are 15.5 percent for single-family units and 9.9 percent for San Francisco's total housing stock.

The impact on structures with from 2 to 4 units is similar to that on single-family, owner-occupied units--that is, heavier than on large apartment units. While some older, large apartments will be affected, many units will not be facing any sizable tax increase. Some structures now assessed at close to the 25 percent ratio will be the recipients of substantial windfalls as their tax bills decline. No attempt was made to quantify this statement because data in this category was not available.

### The Effect on Long-Run Cost of Housing

Owners of single-family housing units will bear the brunt of the tax increase. Since the majority of these units are owner-occupied, the impact of the tax increase cannot be passed on to renters. These owner-occupants will face the dilemma of having to pay the increased tax if they wish to stay in their houses, or of selling the house to a buyer, who, because of higher taxes, may offer less for the house. As an example, consider single-family houses with five to six rooms in standard condition. This group makes up approximately 22 percent of the City's total housing supply. The maximum drop in value here could be 15 percent, though in reality the value drop will probably be somewhat less. While the new tax will be more than double the existing tax for these units, the average homeowner in these houses could absorb all of the increased tax forecast by paying an additional 2.4 percent of his income for shelter costs. There seems little doubt that many of the owner-occupants will elect to do this

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6. See Appendix A. This figure closely corresponds with the magnitude of the tax shift discussed in Chapter I.

rather than put their houses up for sale. In many cases, however, real annual increases in money income will not be large enough to prevent the substitution of increased housing expenditures for other items in family budgets.

The impact on rents will be much less than the full impact of the tax on the owners of the structures themselves. Affected units are more likely to reflect the situation indicated in Table 10, wherein the tax was capitalized, than in Table 9, where the tax was forward shifted. This judgment is heavily influenced by indications that new rental units will not face higher operating costs due to increased taxes. Some renters would eventually be induced to leave existing units, if their rents were to climb, and move to newer units. The resulting vacancies in older structures would work to lower some rents in these structures. Nevertheless, some overdue rental increases will probably emerge as the owners of older rental units seek relief from the increasing taxes.

Another significant effect of the tax will be to accelerate the shift away from single-family units to apartments. This shift is already taking place: the trend toward the diminishing importance of single-family houses in San Francisco is evidenced by the breakdown of new construction between 1960-65. Only 15.4 percent of new residential construction in the City during this period was devoted to single-family houses. On the other hand, while the total amount of demolition was less than new construction, 31 percent of that demolition was in single-family houses. (See Appendix B for a breakdown of this construction and demolition.)

The diminution in the value of some single-family units, coupled with higher operating costs, will make the replacement of these units by apartment houses more attractive. The single-family units most likely to face some shrinkage in the long-run are the approximately 15,000 units inhabited by households with no children and incomes of less than \$4,000.

#### Effect of the Tax on the City's Ability to Attract Middle-Income Residents

The analysis does not indicate that increasing residential property taxes will strongly deter middle-income families from coming to San Francisco. This is primarily due to the overall restructuring of the housing stock which is likely to occur in the long run.

It would appear that the main impact of an increase in the effective residential property tax burden would be to render that segment of the housing stock where rents will be increased too expensive for low-income families. The decrease in demand will lower the market value for this type of housing. It is reasonable to expect that marginal housing of this type will be the first to be demolished and converted to higher-intensity land uses since middle-income

families do not choose to live in such dwellings. The new wave of construction will probably result in the attraction of larger numbers of middle-income, unattached individuals and married couples who want to live in apartments.

It is, however, also reasonable to expect that zoning will effectively constrain the conversion of a large portion of this housing stock to higher-intensity use. To the extent that zoning ordinances impede such conversion, owners of the existing housing stock who are forced to sell will probably capitalize the tax and sell at a lower price to families who will be largely unaffected by the tax increases.

## PROPERTY TAXATION IN THE BAY AREA

It is not sufficient to look only at the impact of tax changes on the San Francisco housing market. There remains the impact of the differences in tax rates among Bay Area communities. Historic differences in tax rates, assessment ratios, and tax burdens have played and will continue to play a role in individual locational decisions. The following section analyzes this situation.

### Significance of Differences in Nominal Rates

Property tax rates considered alone are poor indicators of an area's tax burden. There are two reasons why this is so. First, tax rates may apply to differently assessed tax bases. An assessor in one county had the option, before the enactment of AB 80, to ignore the state's constitutional requirement that property be assessed at full value, and then to assess property at almost any fraction of its market value that he chose. Second, the property tax may not be the only source of local tax revenue. In some cities property taxes (and rates) may be kept relatively low by placing part of the burden on city residents by means of nonproperty taxes. As elementary as these points seem to be, they are worthy of restatement since discussions of property tax rates per se seem popular, and examples of misinterpretation of their significance are frequent. There are, however, a limited number of points worth discussing in respect to Bay Area tax rates per se and their probable spatial effects.

### Increases in Rates Noted Throughout Bay Area

Tax rates throughout the Bay Area have climbed steadily upward in recent years. (See Table 11.) The current San Francisco property tax rate is more than \$2.50 higher than it was in 1959 (roll year). Other Bay Area communities have experienced similar rate increases. During the next few years, application of standard assessment ratios under AB 80 will almost certainly create

TABLE 11

AVERAGE PROPERTY TAX RATES LEVIED IN SELECTED BAY AREA  
COUNTIES<sup>a</sup> FISCAL YEARS 1961-66

<u>County</u> <sup>b</sup>	<u>1960-61</u>	<u>1961-62</u>	<u>1962-63</u>	<u>1963-64</u>	<u>1964-65</u>	<u>1965-66</u>
			(Per \$100)			
Alameda	\$9.11	\$9.27	\$9.50	\$9.73	\$10.20	\$10.53
Contra Costa	8.52	8.59	8.64	8.85	9.11	9.62
Marin	7.96	8.51	9.07	9.06	9.37	9.48
San Francisco	8.41	8.34	9.21	8.93	9.15	9.99
San Mateo	8.50	8.37	8.60	8.77	8.56	7.79

- a. As levied on unequalized property values: the reader may make only limited comparisons between counties with such data because of unequalized assessment.
- b. Rate not strictly comparable with official rate; computed by dividing total levies by the assessed value and multiplying by 100.

Source: State Board of Equalization, "Assessed Value of Tangible Property Subject to Local Taxation by County" for fiscal years 1961 through 1966 (mimeographed).



the illusion that the rates have temporarily ceased their upward motion. However, any apparent pause in the rise in rates will be the result of administrative manipulation of the tax base itself; thus, the area's tax bill should continue upward unabated despite any nominal lowering of the rate.

### A Tax Burden Comparison

The burden of property taxation is viewed in this discussion from two vantage points. First, the net burden of property taxation is measured and compared in Bay Area counties. This analysis is designed to illustrate the heavy weight which property taxation carries in the Bay Area urban economy. Second, the analysis appraises the way in which the property tax burden directly affects the residential property taxpayers. It is hoped that this will provide some insight into the real meaning of property taxation for the homeowner by providing a provisional answer to the frequently asked question, "Can the San Francisco homeowner get a better tax break in another county, but still remain in the Bay Area close to the amenities at its core he esteems so highly?"

Ample evidence is presented in Tables 12 and 13 to suggest that effective property tax rates in San Francisco have not been out of line with those prevailing in neighboring communities. It appears that not only were San Francisco rates not especially high, but also that San Francisco's capacity to support its existing rate level ranked very high in relation to its neighbors. With the exception of Marin County, which boasts a substantially lower rate than do any of the other counties in the sample, most Bay Area counties are brushing against a 2 percent effective rate. Although the legal rate may be in the area of 10 percent, fractional assessments pull the effective rate down substantially below this point. Experience with local property taxation in other American communities has demonstrated that a community can move into the "2 percent plus" effective rate zone, without major taxpayer-voter disturbances.<sup>7</sup>

Although closer inspection of the Bay Area would probably reveal localities which, because of fewer superimposed special districts or special access to highly assessed property (an industrial enclave), had much lower tax rates than any of the "average" rates cited in Table 12, and therefore were in

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7. According to the Bureau of Census, there are a number of states whose local general property taxes exceed 2 percent. As early as 1962, New Jersey (2.6 percent), Rhode Island (2.2 percent), New York (2.5 percent), Massachusetts (2.7 percent), Wisconsin (2.1 percent), Vermont (2.2 percent), and New Hampshire (2.3 percent) all displayed average effective rates of property taxation for locally assessed property which exceeded the present effective rates prevailing in the Bay Area. See U. S. Bureau of the Census, Property Taxation in 1962, State and Local Government Special Studies, Number 47.

TABLE 12

THE BURDEN OF PROPERTY TAXATION RELATED TO PROPERTY VALUES  
AND POPULATION IN SELECTED BAY AREA COUNTIES FISCAL 1965-66

<u>County</u>	<u>Total Property Tax Levies<sup>a</sup> (thousands)</u>	<u>Average Tax<sup>b</sup> Rate (per \$100)</u>	<u>Effective Tax Rate (per \$100)</u>
Alameda	\$192,500	\$10.53	\$1.94
Contra Costa <sup>c</sup>	116,915	9.62	2.12
Marin	40,707	9.48	1.73
San Francisco	168,684	9.99	1.95
San Mateo	110,823	7.79	1.98

a. Includes combined city, county, school district and special district levies.

b. Rate not strictly comparable with official rate; this rate was computed by SBE by dividing total levies by assessed value and multiplying by 100. It should be pointed out that outside of San Francisco where the county and city are coterminous, no individual may be expected actually to pay this rate since it is an "average" rate for all local governments and districts within the county. However, if the assumption is made that the county is reasonably homogeneous economically, the "average" rate is useful.

c. Because of its large nonurbanized portions Contra Costa county is not well suited to this type of comparison. (There are substantial differences between revenue and expenditure patterns in the different areas.)

Source: Computed from State Board of Equalization and Department of Finance data published in the California Statistical Abstract, 1964.

TABLE 13

FULL CASH VALUE OF PROPERTY AND PER CAPITA PROPERTY VALUES  
FOR SELECTED BAY AREA COUNTIES FISCAL YEAR 1965-66

<u>County</u>	<u>Full Cash Value of property (millions)</u>	<u>Population<sup>a</sup> (thousands)</u>	<u>Per Capita Property Values</u>
Alameda	\$9,900.4	1,032.6	\$ 9,590
Contra Costa	5,517.7	509.6	10,830
Marin	2,356.1	188.6	12,490
San Francisco	8,643.1	743.1	11,630
San Mateo	5,587.0	526.9	10,600

a. Population as of July 1, 1965.

Source: Computed from State Board of Equalization (unpublished data) and Department of Finance data published in California Statistical Abstracts 1966

a position to capture San Francisco commerce and industry, it is clear that San Francisco's rates per se are, on the average, not a particular source of concern in themselves. At least they are not out of line to the degree that they, alone, would constitute a deterrent to property ownership.

### Fiscal Capacity of the City

San Francisco is not a poor community. While the City's per capita tax rates were found to be high in comparison to the other counties in the sample, taxes related to property or income were not. Per capita property values were close to the highest among the Bay Area counties (see Table 13). When related to personal income, taxes in San Francisco were significantly lower than the remaining sample counties.<sup>8</sup>

The data suggests that in comparison to other Bay Area cities, San Francisco has the capacity to support the present burden of property taxation without undue hardship. It also implies that the City probably has the option of increasing property taxes without promoting excessive dislocation and outmigration. This does not mean, however, that such an alternative is desirable.

A comparison of residential property tax burdens in the Bay Area further suggests that the San Francisco taxpayer-homeowner has a lower tax bill than does his suburban neighbor. While rates may be roughly comparable, Marin County excepted, (see Table 12), assessments have been quite dissimilar. The data below indicate recent median ratios of assessed to full cash value for all counties in our sample with the exception of San Mateo. The names of these counties have been suppressed at the request of the state authorities.

<u>County</u>	<u>Residential Real Property Median Ratios</u>
A	22.4 <sup>97</sup> %
B	19.5
C	16.6
San Francisco	9.1

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8. For a recent year (1965-66) property tax levies per \$1,000 of personal income were as follows: Alameda \$57.00; Contra Costa \$82.00; Marin \$35.00; San Francisco \$32.00; San Mateo \$59.00.

A typical home in San Francisco would have been assessed so low in proportion to its appraisal value (a \$60,000 home would be assessed at \$5,460) that the effective residential property tax rates on comparable property could be less than half those in other Bay Area counties despite the fact that the normal rates were of similar magnitude. Although many homes in San Francisco, particularly the newer ones, were not assessed at such low fractions, over half the residential housing stock was assessed at 9.1 ratio or below.

#### Implications of Intercounty Residential Property Tax Differentials

Assuming that the owner of a hypothetical home in San Francisco had the option of finding comparable living space in one of the other Bay Area counties, there is still little reason to believe that he would move simply because his tax rate had increased. For not only would he personally realize the loss in value to his home that would occur as a result of the capitalization of the tax increase, but he would also have to move into an area where the tax bill was just as high, if not higher. Moreover, there is good reason to believe that since his home was older and in poorer condition than many in the surrounding region, he would have a great deal of difficulty in finding a comparable house without severely distorting his family budget.

It is safe to conclude from both this analysis and that of the previous section, therefore, that the overwhelming majority of people living in older San Francisco dwellings are "locked in" because: (1) taxes are higher outside San Francisco; (2) they will realize a loss through capitalization of the tax increase; and (3) the housing stock is essentially not comparable.



## CHAPTER III

### A RATIONALE FOR TAX DIVERSIFICATION

The City of San Francisco has traditionally depended upon the property tax to provide almost 90 percent of its tax needs. (See Table 14.) In light of reassessment, the City's fiscal outlook, and the nature of the property tax itself, the wisdom of continuing to rely so heavily on this single impost may be seriously questioned. A composite argument for tax diversification, offered here is based upon several classic indictments of the institution of property taxation as well as unique criticisms founded upon current reassessment-engendered issues. Considerations of the classic type include: (1) the tax's weak justification for existence on either equity or benefit grounds; (2) its administrative imperfections; and (3) its celebrated lack of neutrality. Among those criticisms directly applicable to the San Francisco situation are those based on: (1) the tax's revenue inelasticity; (2) the reassessment-engendered shift problem discussed and quantified in the preceding chapters; and (3) the anticipated high degree of reliance on property taxation by the proliferating tiers of regional government in the Bay Area.

#### SUSTAINED PRESSURE ON RATES EXPECTED

Central to the argument that property tax rates will go up in the long run, and thereby compound the faults of the existing property levy, is the assumption that tax requirements will increase in the coming years. Barring the introduction of a major non-property tax or huge infusions of state and Federal aid, the rising costs of government will inevitably be paid for through higher property tax rates.

1. The mechanics of setting a tax rate may be summarized as follows:

$$R_t = \frac{(E-F) + M}{V} \quad \frac{E - (F+M)}{V} \quad + G$$

where

$R_t$  = tax rate

E = operating expenditures, interest and debt repayment

F = previous years fund balances or surpluses

M = revenues other than property tax (e.g., taxes, inter-governmental payments, charges, etc.)

V = assessed valuation





TABLE 14

## DISTRIBUTION OF CITY TAX COLLECTIONS BY MAJOR TYPE

(Fiscal Years 1962-67)

Type of Tax	Amount (thousands)						Percent Distribution					
	1961-62	1962-63	1963-64	1964-65	1965-66	1966-67 <sup>a</sup>	1961-62	1962-63	1963-64	1964-65	1965-66	1966-67 <sup>a</sup>
Property	123,906	141,034	140,154	148,114	170,226	189,136	86.7%	87.9%	87.4%	87.6%	88.6%	89.1%
Sales and Use	17,382	17,670	18,395	18,964	19,851	20,750	12.2	11.0	11.5	11.2	10.3	9.8
Hotel room	1,144	1,224	1,271	1,477	1,650	1,650	.8	.8	.8	.9	.9	.8
Franchise	474	482	489	509	510	510	.3	.3	.3	.3	.3	.2
Total	\$142,906	\$160,410	\$160,309	\$169,064	\$192,237	\$212,046	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

<sup>a</sup>Preliminary

Note: Detail will not add to zero due to rounding.

Source: Controller's Office data.

## HIGHER COSTS OF GOVERNMENT

These costs are the result of such factors as: (1) industrialization; (2) urbanization; (3) inflation; (4) the changing tastes of citizens for public goods and services; and (5) changes in the locus of responsibility for performing governmental functions. It is beyond the scope of this study to comment fully on some of these factors; however, it is important to paint a backdrop composed of brief sketches of all these factors against which the tax rate problem becomes more visible than otherwise would be the case.

The first two factors, industrialization and urbanization, are so comprehensive that some may contend that they subsume the rest. Some readers may ask what they have to do with San Francisco, a city which, when measured by relevant indexes of either factor, is already mature. While it is true that San Francisco's population has already stabilized and that the City now could hardly be considered a potential location for, say, heavy industry, it should not be forgotten that San Francisco is an organic part of a region, the Bay Area, which is still growing, i.e., becoming both more industrialized and highly urbanized. These two factors, operating within a regional context, have thus had an impact on San Francisco. For example, urbanization of the region has been accompanied by population migrations that are changing the very function of the City away from being a home for middle-class families with children toward the increased accommodation of lower-income, less-affluent families. This transition has resulted in a series of social problems commonly associated with lower-income and/or minority groups. Urbanization and industrialization of the rest of the region have also presented difficult problems to the City regarding water and air pollution control, garbage and refuse collection and disposal, and the easing of the transportation burden. Moreover, a large backlog of unmet social and environmental problems continues to build up within the whole region. Such regional problems have created implicit future commitments that will have to be met largely from San Francisco and Bay Area revenues.

The future implications of increased urbanization and industrialization of the Bay Area may be seen more clearly by examining the problem posed by greater participation in regional government. At present the Bay Area contains several regional governmental agencies: the Association of Bay Area Governments (ABAG), the Regional Air Pollution Control District, the Bay Area Rapid Transit District (BART), the Bay Area Transportation Commission, and the Bay Area Conservation and Development Commission. As the region grows, San Franciscans will become increasingly involved in the activities of these governmental entities. This involvement will, of course, entail raising more revenue to support their work. It is likely that certain functions not now handled on a region-wide basis, e.g., the disposal of solid wastes and garbage, will be so handled in the future. What is of particular relevance to the San Franciscan is that there are indications

that regional government will make additional tax claims against the property owner. Already BART and the Air Pollution Control District have done so, albeit lightly. If property taxation becomes the main vehicle for financing Bay Area regional governments, as it may, this taxation could, when combined with a local conglomeration of property tax rates, become a major source of citizen unrest. This layering of property taxes lies potentially just over the horizon. If this contention is correct, the City must anticipate the obnoxious effects of more property taxation by beginning to diversify the local tax structure.

Inflation is another major source of concern to San Francisco, since government is a labor- rather than capital-intensive industry, and as such, its costs tend to rise faster than they would in more balanced industries. Wage and salary schedules are likely to increase at a rate perhaps as high as 6 or more percent per year.<sup>2</sup> In San Francisco, where a well-entrenched, charter-protected civil service stands guard over thousands of positions, and where there are stronger demands than ever for collective bargaining procedures patterned after those currently employed by organized labor, it is difficult to imagine how the City could ignore major wage and salary demands. The current thrust to unionize the Municipal Railway and extend collective bargaining rights to its employees is a pertinent example. These same forces will also combine to slow down efforts to mechanize many office and clerical operations, efforts which might offset the rise in salaries.

The developing taste of San Francisco residents for higher-quality public services is another factor exerting a strong influence on expenditure levels. Pressure to improve schools, transit, health and welfare appears to be virtually incessant, and there is no reason to suspect that the City's residents will want anything but better performance of urban functions. This observation is based upon the experience of all governmental bodies since World War II.

The locus of responsibility at which a service is performed and financed constitutes another crucial factor influencing local government expenditures. If the responsibility for performing an urban function moves downward from the state to a municipality, the state may also be able to shift, in whole or in part, the burden of financing the function to the municipality. In doing so, the state will not be lowering the community's net contribution to the support of state government if the state holds its aggregate expenditure level constant. Thus the local taxpayer can easily be short-changed by such a shift if the benefits to local beneficiaries from new state programs fall short of those spun off the shifted one.

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2. Various public officials indicated that a rise of 6 to 9 percent per year could be expected; this study made no attempt to independently document or verify this rate.

The health and welfare fields in California present this sort of problem to local government. For instance, "alcoholism" remains one of the major unmet problems in the health field. San Francisco consumes extremely high per capita quantities of alcohol, due only in part to tourism. Further, San Francisco has an extremely high rate of alcoholism. Currently, there is a serious question as to the degree and extent to which the state will continue to operate some of its alcoholism programs in its hospitals. These programs have been utilized to a great extent by San Francisco in recent years. San Francisco officials feel that if the state curtails these services, the City would be faced with a decision either to finance these services or face an unpopular decision to "unplug" an ongoing program.<sup>3</sup> "Mental health" constitutes another opportunity for the state to shift both programs and costs to the local level. Under existing Short-Doyle legislation, many new programs have been made available to local jurisdictions. Informed estimates indicate, therefore, an approximate doubling of mental health expenditures by the City and County of San Francisco, with the City picking up at least 25 percent of the incremental costs.<sup>4</sup> These increases will materialize as the City implements programs authorized under state law.

Finally, a realistic appraisal of the current climate of government at the state level would give some evidence that the state will not be as quick to get involved in certain programs as it has in the past. The present administration recently took office behind a 1.5 million plurality; it appears dedicated to keeping many programs on the local level and to placing others, now administered by the state, on the local level. It is not our intent to comment upon the desirability of having more or less government at either level. This is a highly emotional issue involving economic and political philosophy, and is clearly beyond the scope of this study. An important related point, however, is that some San Franciscans may well be "out of tune" with present political reality if they think it will be possible to shunt the costs of new programs to the state. The "safe" conclusion which should be drawn from recent state-wide political developments is that San Francisco should not look to Sacramento in the immediate future to support a wide range of needed new programs or to improve those existing. (This statement obviously does not imply that the City should not attempt to maximize financial assistance from the state when it is available and when this is seen as a desirable objective.)

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3. No estimates of the costs of these programs were available.

4. This study made no attempt to analyze the legislation and financial planning relevant to this field; the commentary above is based upon discussions with knowledgeable public officials.

## PROPERTY TAX UNRESPONSIVE TO CHANGES IN THE URBAN ECONOMY

The City's property tax base cannot be expected to grow as rapidly as its economy. This is a classic criticism of the property tax and appears entirely defensible based upon examination of recent data.<sup>5</sup> Between 1959 and 1964 personal income for the City registered a 25.8 percent increase. During this same period total assessed values rose only 17.9 percent; this produced an elasticity coefficient of .7 for this impost. However, by raising the property tax rate from \$8.09 to \$9.23, a 14 percent rate increase, it was possible to produce changes in yields of a sufficient size to posit an elasticity relationship slightly greater than unity. Although it may be argued that elasticity of actual revenue or yield is the appropriate indicator of the ease with which the property tax may be adjusted to produce more revenue, it is also true that the property tax may be crossing a "threshold" beyond which increased revenues may be exacted only by means of higher rates--rates that will stimulate increased taxpayer resistance.<sup>6</sup> Unfortunately, this condition cannot be demonstrated empirically, but discussions with influential persons in the City's decision-making process lend it some credence. One could conclude, although tentatively, that the City has had an easier time raising taxes from \$8.00 to \$10.00 under the previous set of fractional

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5. A plethora of studies exists on the responsiveness of the property tax to change in income, (i.e., the notion of the income elasticity of the base). See Dick Netzer, *Economics of the Property Tax*, (The Brookings Institution, Washington, D.C., 1966), pp 184-190. While one strains to draw conclusions concerning the elasticity of the property tax base in the Bay Area, based upon experience elsewhere, it appears reasonable to assume that the property tax base in San Francisco will not be as elastic as are those in the rest of the Bay Area since the City's rate of residential construction should be significantly beneath the rest of the region's. Thus, the elasticity coefficient for the City's base should be significantly below unity while the coefficient for the other Bay Area communities may come much closer to approaching this mark. A possible partial offset however, will come in the direction of massive infusions of value from such complexes as Rockefeller Center which, according to reports, may add as much as \$3 million annually to collections.
  6. In another section of this report it is pointed out that San Francisco now has an effective rate exceeding two percent, and is rapidly approaching the high property tax class among cities.

assessment ratios than it will under the new standardized one. The recent "Eighth Annual Report of the Advisory Commission of Intergovernmental Relations" has already noted increasing and widespread taxpayer resistance to state and local tax increases. Thus, one may not count on achieving a projection coefficient of unity for this tax no matter which elasticity measure is employed, the base or collections.<sup>7</sup> (Table 15 contrasts yield elasticity of the property tax against other major non-property taxes.)

## REGRESSIVITY<sup>8</sup> OF PROPERTY TAXATION

The dominance of the property tax in the City's tax structure is nearly complete. To question the equity of the property tax is tantamount to bringing into question the entire San Francisco tax structure. Chapter II provided a partial pattern of the residential property tax. Increases in the percentage of rent to income after tax were found to be consistently higher for low-income rather than high-income households. This suggests that not only will lower-income households bear a larger proportion of the incremental tax increases, but also that the existing burden of property taxation was regressively distributed. In order to bring this issue into sharper focus, Table 16 and Figure 3 show the existing residential property tax burden as a percent of after-tax money income. The distribution of the burden is quite obviously regressive: as income rises, the burden falls. This finding involved the assumption that housing expenditures are proportional to Bureau of Labor Statistics data on shelter expenses (the allocator employed), and that the tax was, in effect, shifted forward to households acting as consumers of housing.

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7. It should be pointed out that the growth in assessed values is a function of another important variable, the administration of the tax itself. During the 1959-64 period selected for the above investigation, SBE assessment ratios were reasonably constant for the City and hovered in the area of 22-24 percent.
  8. A regressive tax is defined as one that places the money burden of the tax proportionally more heavily on low-income families than on high-income families. A proportional tax is one that represents a constant percent of a family income no matter how much money it makes. A progressive tax burdens higher income families more heavily than those with low incomes.

TABLE 15

INCOME ELASTICITY OF MAJOR STATE AND LOCAL TAXES<sup>a</sup>

Tax	Range of Estimates <sup>b</sup>
Individual Income	1.5 - 1.8
Corporate Income	1.1 - 1.3
Property	.7 - 1.1
General Sales	.9 - 1.05
Motor Fuels	.4 - .6
Tobacco	.3 - .4
Alcoholic Beverages	.4 - .6
Selective Sales	.9 - 1.1
Motor Vehicle Licenses	.2 - .4
All Other	.6 - 1.2

<sup>a</sup> Income elasticity may be defined as the per cent change in tax yield per 1 per cent change in income.

<sup>b</sup> For individual authors see Federal-State Coordination of Personal Income Taxes, Advisory Commission on Intergovernmental Relations, Washington, D.C., October 1965, p. 42.

TABLE 16

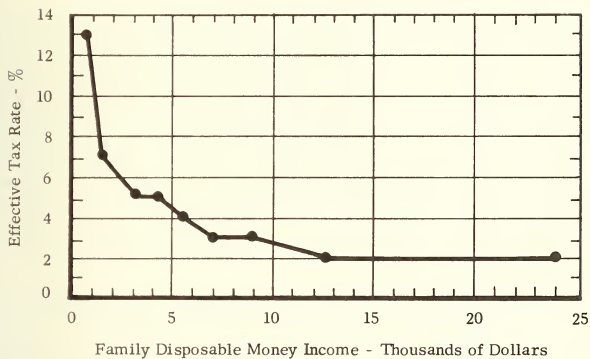
ESTIMATED DISTRIBUTION OF RESIDENTIAL PROPERTY  
TAX BURDEN ON CITY FAMILIES BY INCOME CLASS  
1965-66

Income Class	Estimated Money Burden	Money Burden as Percent of Income (effective tax rate)
Under \$1,000	\$ 59	13%
\$1,000 - 1,999	109	7-
2,000 - 2,999	138	6
3,000 - 3,999	162	5
4,000 - 4,999	208	5
5,000 - 5,999	230	4
6,000 - 7,499	228	3
7,500 - 9,999	286	3
10,000 - 14,999	260	2
15,000 and over	445	2

Note: Assumes property tax payments are proportional to shelter expenditures.

Source: Computed from Bureau of Labor Statistics, Survey of Consumer Expenditures 1960-61, San Francisco, California, 1960-61, data and ADL estimates of residential property tax burden 1965-66.





Source: Table 6

FIGURE 3 ESTIMATED DISTRIBUTION OF RESIDENTIAL PROPERTY TAX BURDEN BY INCOME CLASS, 1965 - 1966

However tentative these findings may be, the regressivity portrayed can hardly be regarded as very surprising. Indeed, investigators in other areas have concluded that the property tax, and particularly the residential component of the tax, is regressive no matter which income concepts are employed and no matter which assumptions are chosen relative to the capitalization of certain types of property values. In fact, a recent California study made at the state level reinforces this conclusion. (See Table 17.)

The introduction of the material presented in Tables 17 and 18 buttresses the finding that the City's own property tax is regressive. Residential property taxation in all four states analyzed was found to be essentially regressive throughout the income range. Further, the property tax considered in its entirety also moulded into a regressive form. This was so despite the fact that incidence assumptions varied, and the income concepts against which the burden was measured also varied from personal income (California) to adjusted gross income (Wisconsin). However, the regressivity displayed in the residential distribution is offset in the highest income ranges when commercial and industrial property are included in the allocations. This occurs because commercial and industrial property is heavily owned by people in the uppermost reaches of the income scale, thereby imparting a note of progression which produces a "U" shape incidence profile.

Taxes on this class of property owner pose a special problem for San Francisco. The burden of property taxation on commercial and industrial property rests either on a firm's customers, who pay prices containing a forward-shifted tax element, or on the owners of the factors of production employed by the firm. San Francisco residents do not constitute the sole market for the City's output. Many of the intermediate and end products (and services) generated in San Francisco are exported to markets outside the City. A large part of the commercial and industrial tax burden is thus exported to out-of-City consumers and may not be regarded as a burden on San Francisco residents. In those cases where market conditions prevent tax exporting (i.e., where an increase in price would result in a precipitous drop in demand) the tax is borne by the owners of the factors of production, who also originate mostly outside the City. Decreases in wages, dividends, and renters attributable to a tax increase will thus affect other Bay Area residents (although San Franciscans do provide nearly three fourths of the region's labor force). Whether the tax will be shifted to one or the other of these factors is a function of the sensitivity to price exhibited by the supply of each. Little is known, however, about the elasticities of these factors in the Bay Area setting.

No matter what degree of potency City-based commerce and industry may have, no matter what degree of market dominance these firms enjoy, it is abundantly clear that the City's property taxes falling on commercial and industrial property will not be fully absorbed by San Franciscans. Even though we

TABLE 17

PROPERTY TAX BURDEN AS PERCENT OF INCOME:  
MAJOR STATE STUDIES

Income Class	State Tax Studies <sup>a</sup>			
	California	Michigan	Minnesota	Wisconsin
Less than \$1,000	(b)	(b)	5.80%	19.38%
\$ 1,000 - 2,000	9.21%	8.71%	2.75	8.98
2,000 - 3,000	10.44	4.99	1.83	6.16
3,000 - 4,000	9.05	3.91	1.57	4.97
4,000 - 5,000	7.99	3.18	1.30	4.35
5,000 - 6,000	7.42	2.86	1.25	3.93
5,000 - 7,000	-	-	-	-
6,000 - 7,500	7.03	-	1.23	3.81
7,000 - 10,000	-	2.43	-	-
7,500 - 10,000	6.19	-	1.78	3.63
10,000 and over	-	2.73	3.40	3.71
10,000 - 15,000	5.01	-	-	-
15,000 and over	5.63	-	-	-

<sup>a</sup>Income concepts: California - personal income, Michigan - money income (before tax), Minnesota - money income (before tax), Wisconsin - adjusted income (revised).

<sup>b</sup>Computed only for under \$2,000 bracket.

Source: California -- Levern F. Graves, "State and Local Tax Burdens in California," "Taxation of Property in California (Sacramento: California Assembly Interim Committee on Revenue and Taxation, 1964), Table XXX, p. 45.

Michigan -- R. A. Musgrave and D. W. Daicoff, "Who Pays Michigan Taxes?" Michigan Tax Study Staff Papers (Lansing, 1958), Table 5, p. 138.

Minnesota -- O. H. Brownlee, Estimated Distribution of Minnesota Taxes and Public Expenditure Benefits (Minneapolis: University of Minnesota Press, 1960), Computed from Table 5, p.22; Appendix A.

Wisconsin -- University of Wisconsin, Tax Study Committee, Wisconsin's State and Local Tax Burden (Madison, 1959), Table 9, p. 57.

TABLE 18

RESIDENTIAL PROPERTY TAX BURDEN AS A PERCENT OF INCOME:  
MAJOR STATE STUDIES

Income Class	State Tax Studies <sup>a</sup>			
	Maryland	Michigan	Minnesota	Wisconsin
Less than \$1,000	(b)	(b)	5.11	14.47
\$ 1,000 - 2,000	3.90	5.05	2.16	5.42
2,000 - 3,000	-	2.71	1.38	3.39
3,000 - 4,000	4.50 <sup>c</sup>	2.02	1.07	2.75
4,000 - 5,000	4.34 <sup>d</sup>	1.63	.89	2.53
5,000 - 6,000	-	-	1.77	2.21
5,000 - 7,000	-	1.51	-	-
6,000 - 7,500	-	-	.67	2.18
7,000 - 10,000	-	1.21	-	-
7,500 - 10,000	4.38 <sup>e</sup>	-	.57	1.97
10,000 and over	3.61	1.01	.64	1.48

a. Income concepts: Maryland - money income (before tax), Michigan - money income (before tax), Minnesota - money income (before tax), Wisconsin - adjusted gross income (revised).

b. Computed for under \$2,000 bracket only.

c. Computed for \$2,000 - \$4,000 bracket only.

d. Computed for \$4,000 - \$6,000 bracket only.

e. Computed for \$6,000 - \$10,000 bracket only.

Source: Maryland Tax Study, Table 9.3, p. 81; Michigan Tax Study, Table 5, p. 138; Minnesota Tax Study, Computed from Table 5 and App. Table 1; Wisconsin Tax Study, Table 9, p. 57.

cannot quantify this, it would be consistent to maintain that residents of the entire Bay Area are probably as deeply involved in these tax shifts as are San Franciscans. Also for this reason, the sudden tax windfalls created by reassessment will largely benefit residents of other Bay Area communities.

In summary, the size of the tax burden, coupled with its regressivity, strongly suggests that future decisions to raise the property tax will result in extracting increasingly larger amounts from those least able to afford tax increases. Thus, the imminent \$29 million shift occasioned by reassessment, coupled with probable future increases in the property tax rate made necessary to underwrite increases in costs of government, will undoubtedly bring continued reliance on property taxation into serious question on equity grounds alone. This finding is consistent with the Chapter II's findings that low-income families are already so saddled with rent payments that attempts to raise rents would be met with a lowering of demand (i.e., families would move outside the City or into less expensive apartments). Although some families may out-migrate, demolition and conversion of low-value rental units to higher-intensity land use will restore an equilibrium between remaining renters and the available housing stock. Presumably these renters will also be the ones who can afford rent increases and who will bear a large portion of forward-shifted property tax increases.

## OTHER SHORTCOMINGS

The regressivity and inelasticity demonstrated in this chapter (and Chapter II) do not constitute the only indictment of property taxation. Continued dependence on this type of impost to a degree equal to or exceeding present reliance will serve to magnify other flaws that will occasionally surface and become visible in the City's tax structure. Unfortunately, the lack of data concerning these defects forces this investigation to discuss them generically as no empirical research was possible. This does not mean that these defects are any less real than those which can be more easily quantified.

### Difficulty of Improving Assessment

Consider the conundrum of "better" assessment. Some observers have attempted to equate the present financial crises brought about by AB 80's standardized assessment ratios with the quality of tax administration under the previous assessor. They seem to be saying that "if only we had 'better' assessments, the City would have no difficulty complying with AB 80's." This line of reasoning is somewhat misleading. It neglects two distinctions needed in any appraisal of the work of the previous assessor. First, assessments among the various classes or types of property may or may not be consistent; second, assessments among properties within a given class or type of property may or may

not be consistent with other comparable properties. The downfall of the previous assessor resulted from problems arising out of the second rather than the first distinction. That is, some properties within a given class, say an inventory, apparently enjoyed a much lower assessment than another comparable inventory. This phenomenon is, of course, wholly undesirable, but it did not place the City in its present fiscal predicament. The first type of assessment problem, the assessment of whole classes of properties at different fractions of market value, has caused the reassessment or "shift" problem discussed at length in Chapter I.

Was the shift one man's fault? Could an assessor force a systematic aberration of startling proportions on the people of the City for decades? No final answer is possible, but there is good reason to believe that he could not. If there is collective responsibility on the part of the entire San Francisco community for these ratio differentials there was no real injustice done to any groups, at least in the ordinary sense of the term. The people of San Francisco, indeed the people in most cities in the United States, subscribe to the notion that business property should bear a larger burden of taxation than residential property. Systematic underassessment of residential property may be regarded, therefore, not as a creation of one man, the assessor, but of the body politic itself. As such, it is fruitless to discuss the "blame" for the existing pattern of assessments among property classes. Thus, if there is to be any indictment of the existing pattern of assessment ratio, it will be on economic efficiency, rather than ethical, grounds.<sup>9</sup>

The point of this discussion is that property tax assessment appears inconsistent not because assessors lack initiative or are dishonest, but because there exists enormous institutional pressure to twist the property tax and its administration to achieve certain community goals; e.g., taxation of business to relieve the burden on homeowners, the support of church-related activities (by means of tax exemptions), and the relaxing of tax rules involving those members of the community, such as the retired elderly, who may find property tax bills particularly distressing because their current incomes have dropped appreciably below normal levels. Pressures of this sort usually build up on the assessor in proportion to the property tax's importance in the local tax structure and rising tax bills. Indeed, it may be that "poor" assessment thus provides a safety

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9. By way of contrast, it is ethical and legal, not economic, efficiency criteria that enables judgment to be rendered concerning the second type of assessing inconsistency. However, the body politic was never aware of it, obviously never condoned it. (Had the public been aware of this practice, aroused public opinion undoubtedly would have seen to its elimination.)

valve for an otherwise unacceptable and structurally deficient tax. If this is true, the pursuit of "better" property taxation appears quixotic. What this means to San Francisco (and a few other urban areas in the state) is plain. AB 80 is forcing better assessment; in so doing it is destroying much of the tax's administrative flexibility, a quality which probably has allowed it to be relied upon for so long. Now that this flexibility is lost, San Francisco must look in new directions for taxes or surrender traditional public policy objectives in regard to taxation. In short, the administration of the property tax may be improved in a technical sense but the improvements may lead, paradoxically, to the undermining of the original justification of the tax in terms of community goals. If this analysis is valid, the property tax is unsound from a structural-functional viewpoint and alternative sources of revenue must be sought, at least at the margin.

### Lack of Neutrality

The so-called unneutrality of property taxation poses another problem in regard to its further exploitation. The tax affects a wide range of decisions bearing on urban and economic development. While this objection can hardly be confined to the property tax alone since most taxes reach beyond economic surpluses--the ideal base for taxation--its very magnitude and size in relation to other locally imposed taxes serves to enlarge grossly its unneutral effects on decisions to work, invest, locate, and spend in the City. Many of its effects have long since been absorbed into the behavior patterns of the City's investors, consumers, and workers. Thus, the San Francisco businessman has already learned how to substitute labor for capital and real property (if such trade-offs actually exist in San Francisco); the consumer has long made a practice of purchasing single-family, owner-occupied dwellings rather than rented shelter because of assessment disparities between the two types of units; and the worker has learned that he must commute many miles to his job outside the city. For, in regard to this last point, the property tax has contributed to the emergent pattern of urban development in the Bay Area. Space-intensive industries, for example, have migrated out of the City and taken with them many jobs fit for the unskilled and "semi-skilled". (High property tax rates in the rest of the Bay Area combined with zoning have restricted the mobility of many San Franciscans, however, who might otherwise have moved out of the City and followed these jobs.) In connection with desirability of tax neutrality, the question which must be considered is this: Will incremental changes in property taxation be any worse than securing the same amount of additional revenue from other tax alternatives? There are many indications that they can be.

Chapter II illustrated the impact of increased taxes on the local housing market. The buoyancy of the market will undoubtedly be checked, if only in the short run. Because of tax increases, many homeowners will decide to sell.

Developers and real estate operators may now see an opportunity heretofore denied them to make a profit in situations that were unprofitable and in the process alter the very character of the City's housing stock.<sup>10</sup> Chapter V indicates just how neutral various forms of business activity taxes are.

This study did not have access to data showing property tax liability by industry class. Nevertheless we do know, from arguments based on theory, that property taxes have a distinctly unneutral impact on business and can lead to distortions of business decisions. This argument stems from the belief that the property tax provides an incentive for the substitution of one factor, say labor, for another, property. Though in the real world it is difficult to actually perceive such effects, they are by no means absent.

The final set of criticisms relates to a constellation of theoretical problems connected with the tax. The goal of property taxation is to tax that property which generates income for its owners. However, the distribution of property, particularly real estate, among the nation's (and the City's) families is not proportional to their income. In San Francisco, evidence of this disparity is most easily seen by examining the relation between house value and income. A family with a \$10,000 annual income may live in a \$35,000 home; a family with an income perhaps 5 times greater (\$50,000) may live in a home worth about \$100,000 or only three times as much as the home of the lower income family. The previous discussion of the tax's regressivity illustrated this problem in some detail.

A rationale for the property tax based upon benefit criteria also rests on uneasy grounds. City expenditures funded by means of property tax revenue must either increase property values by an amount equal to the capitalized value of the tax bill or provide bearers of the burden of the tax with benefits equal to the burden. However, a substantial part of local expenditures financed through property taxation flows to persons rather than property, thereby undermining the first justification. Further, there is no rational way to link a wide range of public benefits with persons. Consider the beneficiaries of public education. Are these beneficiaries the children, the parents, the owners of commerce and industry, or society at large?

It is possible nevertheless that property owners are recipients of a disproportionate amount of public services and should therefore pay commensurate property taxes. However, the concept of property upon which the tax is

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10. This point is really a result of the unneutrality of sudden reassessment. If standardized assessment ratios had been maintained there would probably have been a slower, more gradual conversion of single-family, owner-occupied dwellings to higher-intensity land uses.



built is really very narrow in that it is essentially limited to inventories and real estate. Neglected in the base are assets consisting of skills and education. As a result, investment in "human" capital remains untaxed. Local public expenditures are largely made for educational purposes, yet human capital is not part of the tax base. Moreover, transformations of capital from one form, say real estate, to another, say a college education, not only result in increased benefits for the individual but simultaneously lower the individual's contribution to government.

Other assets including intangibles are also not covered by property taxation. To the extent that double counting is not a factor (and it is), owners of alternative types of assets not secured by property make no contribution to local government despite the fact that possession of intangibles may be an indication of services received by the owners (e.g., police protection).

The property tax is a reality that San Franciscans will be facing for some time to come. Despite the tax's legion of shortcomings both theoretical and practical, and regardless of the present stress being placed upon this institution by reassessment, the tax is here and will remain into the foreseeable future. However, the tax's flaws, particularly under current conditions, bring into serious question the level of dependence which the City has placed on this tax. The appropriate decision locus is thus at the margin - but it is at the margin where public policy decisions are normally made in this country.

A relevant question that might be asked at this point is: if the property tax is really a poor way of financing the increasing costs of local government how are America's other cities side-stepping greater reliance on this tax? The answer of course is, many cities are diversifying their tax structures.

#### TAX DIVERSIFICATION: NOT UNUSUAL FOR COMPARABLE AMERICAN CITIES

A comparison of 17 cities with populations comparable to San Francisco's shows that eight of them have relied more heavily on non-property taxation than has San Francisco. (See Table 19.) Some cities, such as Washington, D.C., New Orleans and Cincinnati, collect about 50 percent of their taxes from diversified tax systems, whereas San Francisco collects only 17.8 percent (all cities net of the school levy) from non-property tax sources. While the data do not show that San Francisco is completely out of step with comparable American cities, they do suggest that tax system diversification is not at all unusual in urban America, and that the majority of comparably-sized cities have already moved toward tax diversification. In certain cases, the data suggest a much stronger dependence on non-property sources for San Francisco than is the actual case when school financing is brought into the picture. This is so because San Francisco employs a separate levy to finance the school system, while cities such

as New York finance schools from general expenditures that are heavily inclined toward non-property taxation. Table 19, therefore, tends to overstate somewhat San Francisco's dependence on non-property taxation.

TABLE 19  
TAX COLLECTION OF CITIES HAVING 500,000 TO  
1,000,000 INHABITANTS - 1965

City	Tax Collections			Non-property as a percent of total taxes
	Total	Property	Non-property	
	(thousands)			
Baltimore	\$134,677	\$119,574	\$ 15,103	11.2%
Houston	60,937	53,097	7,840	12.9
Cleveland	55,139	52,591	2,548	4.6
Washington D.C.	231,582	78,700	152,882	66.0
St. Louis	75,890	31,472	44,418	41.5
San Francisco	130,874	107,533	23,341	17.8
Milwaukee	50,057	48,176	1,881	3.8
Boston	149,216	146,317	2,899	1.9
Dallas	48,375	41,730	6,645	13.7
New Orleans	38,921	20,314	18,607	47.8
Pittsburgh	49,535	30,611	18,924	38.2
San Antonio	19,504	18,302	1,202	6.2
San Diego	30,671	18,263	12,408	40.0
Seattle	30,387	17,943	12,444	41.0
Buffalo	56,532	52,678	3,854	6.8
Cincinnati	43,681	22,808	20,873	47.8
Honolulu	47,841	35,892	11,949	25.0
Total	\$1,253,819	\$896,001	\$357,818	28.5%

NOTE: Census definitions omit school tax component of property taxes and thereby tend to overstate local reliance on non-property taxes.

Source: Bureau of the Census, City Government Finances 1964-65.

## CHAPTER IV

### BUSINESS TAXATION

For many years Section 24 of the City's Charter effectively diverted official attention from any further consideration of the taxation of business.<sup>1</sup> However, it was not only the existence of this self-denying clause which made discussions of business taxation an unpopular subject. The maintenance of a de facto classified property tax system which taxed residential property at an effective rate far below those applied to commercial and industrial property also served as a cumbersome surrogate for business taxation, and made further discussion of the subject unnecessary. Now that the City is being forced, by the provisions of AB 80, to surrender its "device" for extracting a disproportionate share of total taxes from the business community, a reappraisal of local business taxation seems appropriate. This chapter discusses the justification of business taxation and the problems associated with its incidence and economic effects. Those business levies considered most eligible for possible adoption by the City--gross receipts, net income, and gross margins--are analyzed in detail. It is the purpose of this investigation to examine these taxes in detail and to open up new revenue vistas for the City. Also discussed are two problematic taxes, one on commercial occupancy of space and the other on banks.

#### JUSTIFICATION

Business activity is a popular base for taxation in the United States, and the forms of business taxation are quite numerous. These include taxes on profits, receipts, real and/or personal property used for business, and purchases by business. The business sector provides an efficient instrument from which to collect tax revenues, but it is only an instrument, that is, an intermediary, because the real economic burden of business taxes is borne by individuals, either as consumers, income recipients or wealth holders. Thus, the popular concept of "ability to pay" as a rationale and justification for business taxation has no relevance independent of the ability to pay of business' customers, owners, employees and landlords.

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1. Section 24 prohibits a license tax for revenue on retailers and manufacturers operating at a fixed place of business.

It is quite obvious, however, that the business community is an important consumer (both directly and indirectly) of city services. Although businesses were once taxed for the "privilege" of doing business at a fixed location, modern theorists tend to reject the idea that the granting of a "privilege" constitutes a basis for taxation and state their case within the more modern "benefit-cost" framework. This position reinforces the traditional economic viewpoint that all resources are limited and that their use in one line of endeavor necessarily occasions a "cost" in terms of their foregone alternative uses, no matter which sector, private or public, is involved. Explicit recognition is thereby given to the economic costs of the instrumental services rendered by the City to a business enterprise. In this way the police protection furnished by a city to an enterprise which might not only be owned by non-residents but which may also employ some city residents in its labor force, may be thought to be a cost to the City of San Francisco since it could easily expend the resources represented by this incremental police protection in some other way, particularly by making City residents alone the primary recipients of this potential cost saving. Unfortunately, services such as police and fire protection cannot be sold to specific businesses. A rational allocation of their costs is impossible because they provide benefits which are by their nature diffused. Nevertheless, it is apparent that the business community may be regarded as the collective recipient of the benefits flowing from a wide range of municipal services. Furthermore, it is abundantly clear that they occasion a disproportionate share of the cost of such services as police and fire protection, streets, and sewers, to name just a few. Despite this knowledge of the overall incidence of public benefits and costs, to devise a method of pricing most services for sale to individual enterprises would be impossible. Not only would the mind boggle at the potential complexity of an equitable pricing system for, say, police protection, but also the very nature of the service itself is one which incorporates important benefit spillovers that prevent its sale to individual firms. If one firm buys a given "quantity" of police protection to cover its plant and furnishings, a neighboring plant can refrain from purchasing protection and still in effect be covered. The lesson of this is two-fold: first, the City cannot charge directly for most services to business enterprises; and second, the existence of these special services can be easily demonstrated by the fact that if San Francisco ceased or curtailed vital public services, businesses would have to provide these services for themselves.

Admittedly, no one can really say how much of a contribution the business community should make to pay for the intermediate services extended to it, but it is essential that a form or forms of business taxation be developed which closely approximates the extent to which individual businesses benefit from public services. This study has not attempted to produce any sort of evidence that would demonstrate that San Francisco is now being fiscally exploited by such a combination of non-proprietary firms and commuters. Rather, as its point of

reference, this study assumes that the relative contribution of business to the City in return for public services extended to it was institutionally determined through the de facto classified property tax, an instrument that both homeowner and businessman tacitly accepted for many years. A balance was thereby struck between resident and non-resident homeowner and businessman that provided an operational basis for deciding what proportion of the tax total was to be extracted from each group. Emergent from all this is a principle which appears applicable to any new tax system now that the old one has been destroyed.<sup>2</sup> This principle can be stated thus: although we do not know what the business contribution to the San Francisco government should be, we do know that its size should be no less than that which may be fairly imputed to it prior to the current reassessment of the tax system, provided that no firm is worse off with the non-property tax than it was with the old de facto property tax.

### Scope and Coverage of Business Taxation

Ideally, business taxes should apply to all business activity (which excludes only the government sector and private households):

- (1) All private, profit-seeking enterprises including corporations and unincorporated business (self-employed);
- (2) Mutual financial institutions;
- (3) Cooperative enterprises;
- (4) Non-profit organizations servicing business.

In practice, however, it is extremely doubtful that any business tax structure could be devised for San Francisco which would maintain this complete coverage. Other cities employing extensive business taxation have experienced difficulty in securing full compliance among self-employed persons. Furthermore, it must be recognized that under normal levels of administrative surveillance, some evasion of business taxes is likely.

Bank taxation (which will be thoroughly discussed later) is another important source of tax leakage for the City. Limitations on the taxation of nationally chartered banks has resulted in personal property exemptions at the local level. The state imposes a franchise tax on banks "in lieu of all other taxes and

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2. It should be emphasized that the abolition of de facto property taxes had its impetus from outside of the San Francisco political system. Evidence strongly suggests that San Franciscans would have preferred a classified property tax, even though technically illegal, so long as assessment among classes was honest and efficient.

licenses, state, county and local, except taxes on real property."<sup>3</sup> The rate is 5.5 percent plus another 4 percent to make up for the fact that the banks in California are exempted from paying taxes on their personal property.

Mutual savings institutions have come under the umbrella of the nationally chartered banks and have been granted immunity from a wide spectrum of taxes on the grounds that equity should be maintained between state and nationally chartered financial institutions. This seems to be a logically sound argument until one stops to assess the real implications of adhering to such high standards of tax neutrality. Virtually no business could be taxed if this doctrine of neutrality were strictly observed, since there will always be some taxed firm that is in some structural way comparable to an untaxed firm. It is one thing to work to close loopholes, and it is something else to expand special privileges into universal guidelines of taxation.

Insurance companies also enjoy special tax treatment. Although they pay local property taxes, their California Gross Premiums tax is in lieu of all other taxes and licenses. One could not, therefore, expect to levy a business license tax, no matter how adroitly conceived, on an insurance company without a great deal of litigation.

#### ECONOMIC FEASIBILITY AND APPROPRIATE FORMS OF BUSINESS TAXATION

Is it reasonable to expect that the City of San Francisco can impose a major business tax while the remainder of the region does not? The answer can be affirmative if one considers the present situation and makes a realistic evaluation of the probable impact of the imposition of a well-designed program of business taxation. San Francisco has, in fact, had a *de facto* business tax via the property tax for many years. While it is true that the incumbent system has probably already driven out many space-sensitive warehousing and manufacturing operations, the City has re-emerged with an even stronger office-centered real estate base. If and when another business tax takes up some of the slack from the old property tax, one should not expect to witness a mass exodus of socially and economically desirable enterprises to Oakland or San Mateo. On the contrary, a well-designed business tax extracting up to the same amounts as did the old "classified" property tax should have fewer deleterious effects than did its predecessor. If one assumes that government produces services vital to business enterprise, and if one accepts the fact that the San Francisco

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3. Senate of the State of California, "Taxes on Business Income," Report of the Senate Fact Finding Committee on Revenue and Taxation, Part 4, (Sacramento, California March 1965).



urban complex affords a return on investment not possible in other areas, taxes do not bulk as large in the decision-making process of most executives as is sometimes thought. For the fact is that most of San Francisco's economic base is not "footloose," i.e., locationally mobile. If it were, San Francisco would by now have been an economic wasteland principally because of business property taxes. By the same token, business leaders considering locating in San Francisco are not so short-sighted as to think that they can pay low taxes and still reap the rewards of working in a pleasant, convenient city. In fact, there is probably more evidence to support the contention that a prospective executive would wonder about the adequacy of the transportation system, garbage and trash removal, and the fire department before he inquired about the tax rate.

A positive business climate is best enhanced not by negotiation, but by determining business tax liabilities through the application of clearly defined rules, and by minimizing the necessity for frequent adjustments in rates and structure. Continual uncertainty as to future business tax policy may be more damaging to the prospects of attracting commerce and industry to San Francisco than any other single factor. Thus it is imperative that San Francisco design a business tax structure which both reflects and encourages economic growth and development.

The appropriate method of taxing the City's businesses may take several forms. Business taxes measured in relation to property values are reasonable to the extent that the public services provided enhance the advantages of carrying on business in San Francisco. The volume of business activity, measured perhaps by gross receipts, may also bear a reasonable relationship to the volume of public services used. In this latter case, each unit of any individual business' net output would include a tax component, regardless of the form of business organization (incorporated or unincorporated), or the combination of resource inputs used (land, labor, or capital). In actuality the only business tax base which would truly achieve this result is a firm's gross margin, or what the economist calls "value added." This tax, which is beginning to receive serious consideration as a new source of tax revenue for state and local governments, is computed simply by deducting inter-firm purchases from a firm's gross receipts. This gross margin or value-added concept measures the net output of a firm without regard to whether this output requires relatively heavy inputs of capital, labor, or executive talent.

Acceptance of the principle that business should pay in proportion to the benefits received from city services precludes the possibility of using net income or profits as the sole base for city business taxes. There is no positive correlation between benefits from public services and profitability--San Francisco firms with low profits, or no profits, do benefit from public services provided by the City of San Francisco. But net income taxes must not be excluded from consideration, particularly if used in combination with other levies. Furthermore,

in some cases, such as the national banks, it may be the only alternative way to assess particular industries and individuals for services provided.

Before considering the individual levies, it should be pointed out that in principle, the structure of city business taxation is as important as the level of that taxation. For example, under a gross receipts tax, a firm which pays a tax rate of 0.2 percent when its gross profit margin is 1.0 percent, is paying an equivalent effective rate of 20 percent on profits; while a firm with a profit margin of 10 percent is paying an equivalent effective rate of only 2 percent.

### THE INCIDENCE OF BUSINESS TAXES

It is virtually a truism that the actual burden of a tax may not reside where the government intended it to. This is the basic problem to which incidence theory addresses itself. Incidence is generally defined in the following way. The definition comprehends one of three separate but related processes, impact, incidence and effects; this is the traditional approach.

Impact is regarded as the initial burden falling on the person legally designated to receive it. In San Francisco, for instance, certain license taxes have an impact on business, while the impact of the sales tax is on the consumer.<sup>4</sup> Incidence, however, refers to the ultimate money burden imposed by a tax. By tax shifting, a process by which price and output changes are produced by responses to the tax itself, the tax may move from one group to another provided buyers and sellers are linked in a marketplace. Thus a business license tax may be shifted forward to the consumer in certain circumstances. The effects of a tax would then consist of economic consequences collateral to the incidence and too remote from the imposition to be rated as part of the money burden of a tax. For example, if the government were to levy a tax and then not spend the funds, i.e., sterilize the revenue, aggregate demand would be reduced and the quantity of goods and services produced as well as the price level would be affected. The unemployed might be regarded as chief target of this process and could be said to bear the effects of the tax. In short, incidence relates to the partial-equilibrium or price solution to tax changes while effects would constitute a general-equilibrium or economy-wide answer. No effort has been made to discuss effects in detail as there is inadequate theoretical underpinning and data to properly deduce the final range of effects.

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4. The seller in San Francisco is responsible for collecting the tax and remitting it to the state; the consumer's bill includes price plus tax. Thus the consumer, not the seller, feels the impact.



The degree to which any of the business levies discussed can be shifted depends upon several factors. Perhaps the most important of these factors is the nature and size of the market served by the taxpayer. If the firm being taxed is not in competition with firms operating outside of San Francisco (for example, a San Francisco firm serving the San Francisco market), the possibility of shifting the tax burden to the final consumer is enhanced. On the other hand, a City firm competing in a state-wide or national market would probably encounter more trouble in attempting to shift the tax forward. These firms would be more likely to absorb a large portion of their tax liabilities in the form of lower profits or perhaps reduced wages. To the extent that a firm can shift the tax burden back to the factors of production, the burden of business tax would fall on the area residents, including those living outside San Francisco.

The incidence of the gross receipts tax in part depends upon the extent to which the tax takes on the appearances of a sales tax. Many writers on the subject believe there is at least some forward shifting of the gross receipts tax in the short run. (The shifting is necessary to validate the argument of tax pyramiding.) The most significant thing that can be said about gross receipts taxation is that wherever the final burden comes to rest, the total burden is likely to be heavier than if the tax had been single-staged and applied to final output. It is, however, probable that a smaller proportion of the burden is likely to rest on the consumer under a gross receipts tax than under a sales tax. This is true because the more stages required to pass the entire tax burden on to the consumer, the greater the number of obstacles to be encountered. Compared to the gross margin and net income taxes, the gross receipts tax affords more opportunity to shift the burden of the tax forward, since the tax component of the price is more readily visible and can be more directly associated with individual units of output.

The incidence of the gross margin tax is less predictable. In time it is likely that firms will develop a representative percentage of value-added to gross receipts which they will use in attempting to shift the tax. This is the conclusion reached by Martin Bronfenbrenner in his study of the Japanese value-added tax.<sup>5</sup>

In recent studies of the incidence of the gross margins (value-added) tax, the views imply certain assumptions about the incidence of the excise and

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5. Martin Bronfenbrenner, "The Japanese Value-Added Sales Tax," National Tax Journal, Vol. III, No. 4 (December, 1950).

the corporation income tax.<sup>6</sup> It has been pointed out that gross margin tax is really a hybrid, based partly on costs and partly on net income or profits. The prediction of the incidence of the gross margin tax can be no more precise than the prediction of the incidence of the two individual levies. Largely, the questions raised about the net effects on incidence remain unanswered in the economic literature.

## POTENTIAL BUSINESS TAXES FOR SAN FRANCISCO

### The Gross Receipts Tax

The gross receipts tax provides a potentially wide base for local business taxation since it may be applied at a number of stages in the productive process, and for this reason is often referred to as a turnover tax. When a city's economic base is highly interdependent as in San Francisco's, the gross receipts tax is capable of producing high yields with very low tax rates. It has been used by state and local governments in this country, most notably by New York City. It has also been a distinguishing feature of the tax systems of several European countries, including Austria, Belgium, Italy, Luxembourg and the Netherlands. Within California, the City of Los Angeles raises over \$21 million annually by means of a license tax based on gross receipts. Historically, the gross receipts tax is one of the oldest forms of taxation applied to business activities.

New York City has had more experience with gross receipts taxation than any other government in the nation. The "Business and Financial Tax" package levied by that city was producing over a quarter of a billion dollars annually when it was discontinued in 1966. The New York business tax package consisted of a multi-rate structure including:

1. A 0.4 percent general business gross receipts tax levied on gross receipts exceeding \$10,000 earned or allocable to New York City.
2. A commission-type business gross receipts tax with a \$10,000 exemption imposed at a lower 0.15 percent rate.

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6. Lock et al., Report of the Governor's Minnesota Tax Study Committee, 1956; Peter A. Firmin, The Michigan Business Receipts Tax, Michigan Business Report No. 24 (Bureau of Business Research, University of Michigan, Ann Arbor, 1953).

3. A 1.5 percent financial business gross income tax with a \$5,000 exemption.
4. A 0.6 percent investment companies gross income tax with a \$5,000 exemption.

The multi-structure which characterized the gross receipts tax package in New York City was the result of a series of ad hoc attempts to ease the burden of taxation on firms which had relatively low ratios of net income to gross receipts, e.g., jobbers, wholesalers, and certain financial companies, among others. In 1966, business income tax was substituted for this unwieldy, but extremely successful, revenue producer.

The most appealing aspect of the gross receipts tax is its ability to provide large amounts of revenue at rates which are usually lower than those of any other tax applied to business activities. Furthermore, the yields from the gross receipts tax are responsive to economic growth. As the economy grows the base expands in approximately a proportional manner.<sup>7</sup>

By using a multi-rate structure, a gross receipts tax package may be designed so that major inter-industry inequities are well attenuated. By recognizing the varying relationships between gross receipts and net income (profits), a multi-rate structure could go far to eliminate the discrimination resulting under a uniform-rate tax. By so doing, however, a major advantage of this impost is undermined. It has been argued that because the rate is low and therefore the incentive to evade taxation is also low, the tax is simple to administer. If the rate structure and allocation formulae are complex, which would be necessary to accomplish neutrality, the case for low administrative cost fails. In practice the multi-rate structures that have been used in many cities have reflected the varying relationship between gross receipts and net income only in very crude ways. If pushed to the extreme, a multi-rate structure encompassing complete inter-industry equity would amount to a flat rate business income tax which would certainly be easier to administer.

Therefore, on the plus side, a gross receipts tax has been shown to be a stable and predictable source of city revenue. It possesses the advantages of comprehensive coverage, low rate, and relative stability of yield.

The weakness of gross receipts taxation are legion. Most of these weaknesses stem from the fact that the ratio of profits to gross receipts varies

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7. The responsiveness of an individual tax to economic growth as measured by change in the Gross National Product is referred to as income elasticity. Income elasticity may be defined as the percent change in tax yield per 1 percent change in income. The income elasticity of the gross receipts tax has been estimated between 0.9 and 1.05.

widely not only between industry classification but also between firms in the same industry class as well. Continual pressure is thus applied to change rates so that the impact of the gross receipts tax on certain industries will be softened. No real adjustment seems practical, however, which would insure that firms with unusually low profit margins but which are operative within an industrial classification having historically high profit margins are not seriously handicapped by this impost.<sup>8</sup>

An undesirable effect of gross receipts taxation is derived from the very source which creates the large and tempting tax base, i.e., business turnover. Because the tax is usually imposed at all stages of the productive and distributive processes, the tax tends to pyramid the price structure. That is, the tax gets built into the price of a series of intermediate goods so that by the time the product is ready for final consumer sale its price may contain a large forward-shifted tax cost element or alternatively, may have produced a series of dislocational effects through backward-shifts as the tax gradually ballooned. Often the stepwise price increases exceed the incremental tax costs, a phenomenon referred to as double taxation.

When a community's economic base is highly integrated, the pernicious pyramiding effects of the gross receipts tax are limited and the tax more clearly resembles a single-stage, gross receipts or sales tax. Where a community's economic base is not integrated, where the output of one firm is the input to another (e.g., printing to advertising), pyramiding effects may become threatening to continued operation of certain firms within the community levying the tax. This is particularly true where opportunities to shift the tax forward or export the tax component outside the city are limited. The gross receipts tax places a premium upon vertical integration and concentration of a range of business activity in a smaller number of firms.

The administration of the gross receipts tax appears more difficult than that for the net income tax, but about the same as for a gross margins or value-added levy. It would be necessary for the City to develop a formula for allocating the receipts of firms engaged in inter-city or inter-state business. Not all gross receipts accruing to a firm selling in a national market are usually regarded as taxable. Ordinarily, a locality will attempt to tax completely the gross receipts of firms whose business is conducted entirely within its taxing jurisdiction. By assuming that a portion of a firm's property located within the taxing jurisdiction is used for making sales outside of the city and that a portion of the payrolls paid stems from labor inputs used to produce

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8. During 1962, a plan was developed to take both a firm's net margin and net worth into account by allowing a credit to be made against the gross receipts tax liability for firms which had low ratios of both these items to gross receipts.

goods destined for markets outside the taxing jurisdiction, a portion of an inter-city or inter-state firm's gross receipts may be allocated to the taxing jurisdiction. In any event, the allocation formula is arbitrary but the flaw is endemic to all local taxes on business activity.

In summary, the gross receipts tax is structurally deficient on a number of counts:

1. The tax bears little or no relation to the ability of a firm to support city government.
2. The tax places a premium upon vertical integration and encourages concentration of business activity.
3. The tax results in pyramiding and double taxation because it is applied on the total volume of receipts at every stage in the production and distribution process.
4. Insofar as out-of-city sales are excluded from the base, it bears no reasonable relation to the benefits received by business from the provision of public services. This is further reinforced by the inclusion in the tax base of goods which are not produced in the city.

#### The Gross Margin or Value-Added Tax

The gross margin or value-added tax is unfamiliar to most Americans although it is employed by other countries, including France and Japan. It has been offered as a possible new source of revenue for state and local governments or as a possible replacement for existing business tax levies. In principal it is quite easy to compute a firm's gross margin or value-added. It may be defined as the value of shipments less the cost of materials, supplies, fuels, and the like. Thus it is the total value of output less the cost of inputs purchased from other firms. Alternatively, value-added may be measured by summing the returns to all factors employed in a business, e.g., payrolls, interest, rent and profits. Although it will be pointed out that the local taxing jurisdiction has considerable latitude in the exact method employed in calculating the tax base, it is quite evident that gross margin or value-added taxation provides much broader base than do profits.

This tax has an advantage over the other types of business levies under consideration in that it is neutral with respect to the combination of resource inputs used. In other words, the gross margin or value-added concept measures the net output of a firm without regard to whether this output requires relatively

heavy inputs of land (perhaps measured by rental costs), labor (including executive talent), or capital. In general, the tax is conceptually neutral with respect to type of business activity, form of organization (corporate, partnership or proprietorship), capital structure, and input mix.

It is eminently more reasonable to justify a business tax on the basis of gross margin or value-added than on most other tax bases since the value of the services provided by the city to business is more nearly proportional to the amount of productive activity of each firm as measured by its value-added. In this respect its superiority over the net income tax is uncontested. A business with no profits or losses still receives the benefit of city-provided services, and, under the gross margins tax, would pay taxes on the basis of its nonprofit components of value-added.

It is likely that small business would turn this argument around and maintain that it is onerous to expect an unprofitable firm to pay taxes. This argument is weak in that if it were logically extended, a case could be made for subsidizing the purchase of all intermediate inputs of marginal firms. Often linked to the "unprofitable firm" argument is the "infant industry" argument, although in reality it is something quite different. A value-added tax could be an excessive burden for a firm that is just beginning to produce on a scale which could afford substantial opportunities for profit. There seems to be no reason why this objection to the tax could not be overcome merely by building an adequate exemption into the tax statute that would protect this group of firms.

Although limited application of this tax prohibits extensive analysis of its income elasticity, it is likely that the tax is at least as responsive to economic growth as the gross receipts tax. Furthermore, the tax is characterized by relative stability of yield. Wages, which form a large component of the tax base, tend not to follow in the direction of the downward phase of the business cycle.

Initially, higher administrative costs for the value-added tax should be expected than for a gross receipts tax of equal yield since the tax is unfamiliar to both government administrator and taxpayer. Once all parties adjust to the tax there is no reason why costs should not drop to a level comparable to those for any other business tax. Preliminary estimates indicate that initial administrative costs should not exceed 3 percent with a reasonable level of surveillance. Once the initial educational and public relations efforts are made, administrative expenditures in subsequent years should be substantially less.

In summary, the gross margin or value-added tax has certain of the advantages of the gross receipts tax, namely, relative stability of yield, low rate, and comprehensive coverage. In addition, it has few of the disadvantages found in the gross receipts tax. It is certainly less discriminatory to certain



types of industry and avoids the undesirable effects of pyramiding and double taxation. Also, by providing for the deduction of inter-firm purchases, it provides no incentive for vertical integration.

Because of its relative unfamiliarity, it seems desirable to detail the several variants of the value-added tax. The basic difference among the alternative bases involves the treatment of depreciation of capital equipment. The first, the consumption type, allows the entire cost of new capital assets to be deducted in the year of purchase. The second, the net income type, allows the capital expenditure to be recovered in the form of deductible depreciation allowances spread over the useful life of the asset. The third, the gross income type, does not allow for the deduction of capital expenditures.

As noted, the base may be calculated either by subtracting inter-firm purchases from gross receipts or by adding the factor costs. For purposes of San Francisco taxation it seems best to use the latter or the so-called income or addition approach. This primarily due to the rather difficult conceptual problems involved in measuring the receipts of certain sectors, notably finance. Under this approach the value-added base is derived by adding the payments made to the factors of production, each adjusted in one or more of the ways discussed below:

- Wages and salaries should be adjusted to include the cost to the firm of providing fringe benefits to its employees.
- The adjustment necessary on profits will depend upon the type of value-added taxation. For the net income of the tax base, accounting profits can be taken as reported; for the gross income version, depreciation deductions would be added; for the consumption version, depreciation would be added and capital expenditures made during the year deducted.
- To be consistent and avoid double taxation, the interest paid to other business firms should be excluded from the base since it will be taxed as part of the payee's taxable value-added. In a sense it is an inter-firm purchase of a service. On the other hand, interest payments made to individuals outside of the business community should be included in the tax base of the payor since their exclusion would result in elimination from the tax base. In the case of rent and dividend payments, as in the case of interest payments made to other businesses, the question arises as to which firm has added the value and should be subject to the taxation. Since there is often no clear-cut answer, an arbitrary decision must be made, and the real necessity is for a consistent approach

that both avoids double taxation and includes all value-added in the base. For purposes of City taxation, it is likely that rules to include these payments in the base of the payor rather than the payee will result in a larger value-added tax base for the City. This is true since in the relatively narrow taxing jurisdiction of the City which may not encompass both payor and payee some leakage is to be expected.

- Realized capital gains and losses should be included in the value-added base, and if necessary, accounting profits should be adjusted to accomplish this.
- Profits should be taken before deduction of any taxes. In practice, however, some governments allow deduction of indirect taxes. The major problem in this area involves the lack of a clear distinction between direct and indirect taxes. Fees and user charges paid for governmental services should be deducted as ordinary inter-firm purchases.

### The Net Income Tax

On the basis of the argument that a firm's ability to support the government sector is measured best by its profits, business income taxes have been levied by several levels of government. Business income taxes are currently levied by the Federal government, the states and a few cities. New York City replaced its gross receipts tax package with a business net income tax to improve equity in its business taxation. If enacted in San Francisco, it would be imperative that the business income tax encompass both the corporated and unincorporated segments of the business community.

A net income tax on business provides a real possibility for cooperation between the State and the City. First, it would seem advisable that the City levy a tax on the same income base as the State. For administrative simplicity the City could design its tax as some specified percentage of the State tax. Under such circumstances it would even be possible for the State to collect the tax and refund it to the City. In this way not only would administration of the tax be simpler, but also the taxpayer would probably experience lower compliance costs.

Net income taxes have popular appeal because they tend to equalize the "burden" of taxation among industries. In other words, in the case of a flat rate income tax the "burden" of the tax, measured as a proportion of net income, is the same for all firms.



The corporate income tax also has the advantage of being one of the taxes most responsive to economic growth. Estimates of the income elasticity of the corporate income tax range from 1.1 to 1.3.<sup>9</sup> This means, in effect, that the tax base expands more rapidly than the growth of income in the economy.

In comparison to other alternative business levies, the net income tax base is considerably smaller. Therefore, to raise the same amount of revenue as the other levies would require imposing a higher rate under the net income tax than under either the gross receipts or gross margin (value-added) tax. It might appear that the required rate would be excessive, particularly when added to the rates imposed by the State. Evaluation of the income tax on the basis of rates is invalid when we first assume that a given amount of revenue is to be raised from the business community. As has been pointed out, the effective net income tax rates under a gross receipts tax would be several times the required rate of the net income tax for certain industries. Thus, even with a substantially higher tax rate than under either a gross receipts or value-added tax, the "burden" of the income tax for those industries characterized by high turnover-to-profit ratios would be lower.

If one accepts the principle that business should pay taxes to support city services in proportion to the benefits received, the net income tax base is clearly deficient as a measure of these benefits. Whatever the merits of the tax in terms of measuring ability to pay, it does not provide a reasonable index for measuring benefits. To conclude that it did would be to imply that those San Francisco firms with few or no profits to be taxed received few or no benefits.

In summary, net income provides a familiar base for the taxation of business, a base which is able to provide increasing yields in a growing economy. Because of the narrowness of the base; the rate must be relatively high in comparison to the required rate under a gross receipts or gross margin tax producing equivalent yields. Although it reflects that most businessmen consider to be taxing "capacity" or "ability," it is a poor proxy for measuring the benefits they receive from the City.

#### ALTERNATIVE BUSINESS LEVIES: CONSIDERATIONS OF DIFFERENTIAL IMPACT

It is well known that the forms of taxation are as important a consideration as the levels of taxation to an individual industry. Therefore, any

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9. See the Advisory Commission on Intergovernmental Relations, Federal-State Coordination of Personal Income Taxes, (Washington, D. C., 1965).

appraisal of the alternative business tax levies under consideration would be incomplete without an analysis of their impact on different types of business activity in San Francisco. This section employs the technique of differential impact analysis. Differential impact analysis examines, compares, and contrasts the measured changes in the distributional pattern of tax payments by industry groups associated with the substitution of equal-yield taxes.<sup>10</sup> Because this type of analysis is built upon comparative yields (that is, yields which are equal under each alternative) attention may be focused on the following types of questions:

- Given an amount of revenue to be obtained from the City's business community, what tax or combination of taxes best secures a distribution of the liabilities consistent with policy objectives?
- Would a particular tax, if enacted, be uneven in its distribution among different types of business activity?
- Would a particular tax discriminate against so-called "footloose" operations?
- Can a tax or combination of taxes, if levied, be rationalized on some reasonable and defensible basis?

These questions by no means exhaust the range of possible inquiry into tax alternatives. They are intended only to indicate the range of policy-oriented issues on which this technique of analysis may shed some light.

To compare and contrast tax liability differentials by industry type under several alternative levies requires the computation of simultaneous tax bases. Since the City of San Francisco currently does not employ any of the alternative business levies under consideration, the data for this study were all constructed rather than gleaned from actual tax records. The three alternative taxing bases considered are: gross receipts, gross margins or value-added, and net income. In this study, the gross receipts data were estimated directly on the basis of Census data for those industries for which such data were available.<sup>11</sup> For industries whose gross receipts were not reported by

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10. For a discussion of this empirical-quantitative technique and its use as a policy tool, see John B. Legler and James A. Papke, "Optimizing State Business Taxation: An Application of Differential Impact Analysis," National Tax Journal, Vol. XVIII, No. 3 (September 1965); and "Towards a Rationalization of State-Local Business Taxation," Proceedings, Fifty-Eighth Annual Conference on Taxation, National Tax Association (New Orleans, 1965).

11. U. S. Bureau of Census, Census of Business, 1963 (U. S. Government Printing Office, Washington, D. C., 1965). The data were adjusted to reflect economic growth in San Francisco between 1963 and 1967 by assuming that San Francisco's growth rate was the same as the entire country's.

the Bureau of the Census, estimates were constructed from San Francisco income data by assuming that the ratio of gross receipts to income in San Francisco is the same as the ratio of gross receipts to income in the United States.

The gross margin or value-added tax base differs from the gross receipts base in that it provides for the deduction of all inter-firm purchases. In actuality, the base is equal to the firm's total payments to the factors of production--wages, interest and rents paid, and profits.<sup>12</sup> The estimates used in this study are derived estimates, based on a number of secondary sources, and, to some extent, personal judgments.<sup>13</sup> The gross margins estimates were derived directly without applying an allocation formula to the gross margins of multi-city operations. In actual implementation of a gross margins tax, however, an apportionment formula would have to be included in the taxing statute. This would result in a corresponding reduction in the total tax base. Firms engaged in manufacturing would experience the largest reduction in their tax liabilities because of their inter-regional and national market orientation.<sup>14</sup> Because of San Francisco's relatively small manufacturing sector, the reduction in the total gross margins tax base would not be particularly marked.

The net income tax base was derived directly from California income tax return data. Proprietorship and partnership income was directly allocable to San Francisco from the published reports of the California State Franchise Tax Board. For corporate income, it was necessary to allocate San Francisco's share of total California corporate income by assuming that the ratio of San Francisco's corporate income to California corporate income is the same as the ratio of San Francisco payrolls to State payrolls.<sup>15</sup>

Although absolute precision cannot be claimed for the estimate bases, they are suitable for the intended purposes. The primary concern is with the identification of variations in relative positions, and this may be accomplished without imposing absolute measurement requirements.

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12. For a discussion of the various methods of computing value added, see the Bronfenbrenner study referred to in footnote 5.
  13. Extensive reliance was placed on the following documents: California Franchise Tax Board, Annual Report, 1964; U. S. Treasury Department, Statistics of Income, 1962; U. S. Department of Commerce, Annual Survey of Manufacturers; and U. S. Bureau of the Census, Census of Business.
  14. For a thorough treatment of the gross margin or value-added tax base, see James A. Papke, "Michigan's Value Added Tax After Seven Years," National Tax Journal, Vol. XII, No. 4 (December, 1960).
  15. No dollar exemptions have been provided and the income of professionals has been excluded from the tax base.

Before the differential impact results are presented, the general limitations of this type of analysis should be noted. First, only tax impact is considered; thus, obvious differences in the shiftability of the alternative levies is neglected. Second, a partial analysis of only one sector of the City's economy necessarily neglects spillover (interdependent) effects and perhaps higher-level fiscal goals as well. Thus, optimizing the objectives of business taxation may result in less than full optimization of the fiscal structure as it relates to individuals. Third, stability over time in the distributional relations should not be implied from the cross-sectional analysis.<sup>16</sup> Fourth, although efficiency, equity, and ease of administration and compliance are important considerations in an overall evaluation, they are omitted from the present analysis.

### Results of the Computations

To facilitate the inter-industry comparisons, the tax liability distributions are expressed in terms of percentages of the total tax base. For example, an industry which generates 10 percent of total taxable gross receipts in San Francisco, 5 percent of total taxable gross margins, and 5 percent of net income is assigned the same proportions of the total tax liability under each tax.

Table 20 gives the percentage distributions by industry classification of three alternative business tax programs. This table indicates the relative shares that would be borne by each of San Francisco's major businesses under each tax.

The extent to which tax responsibility would be reordered under the different levies is apparent. The trade industries, wholesaling and retailing, would have their relative shares substantially changed if a net income tax rather than a gross receipts tax were introduced. Wholesaling's relative share under a net income tax would be approximately 43 percent less than under a gross receipts tax. Retailing's relative share would be approximately 23 percent less under a net income tax. The reverse trend holds true for finance, the service trades, and transportation, communications and utilities. Their relative shares would be greater under a net income tax than a gross receipts tax by 91, 145, and 105 percent, respectively. Although the construction industry contributes only a relatively small proportion to either tax base, in percentage terms its relative share would be 30 percent less under the net income tax than under the gross receipts tax.

Manufacturers, as a group, would be responsible for essentially the same share of the total tax base under either the gross receipts or net income tax base. Within the manufacturing sector, however, significant adjustments would occur. Although some manufacturers would have their relative positions

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16. This is particularly true of the net income series. Several studies have disclosed marked cyclical variations over time in the net income series.

TABLE 20

PERCENTAGE DISTRIBUTION OF ALTERNATIVE SAN FRANCISCO BUSINESS  
TAX BASES, 1967

	1	2	3
	Gross Receipts Tax	Gross Margins Tax	Net Income Tax
Construction	3.7	6.8	2.6
Manufacturing	12.0	15.7	11.9
Food and kindred	4.9	4.3	3.3
Textile mill products	.1	.1	.1
Apparel	.9	1.3	.5
Lumber and wood products	.3	.1	.2
Furniture and fixtures	.2	.5	.2
Paper and allied products	.2	.2	.3
Printing and publishing	1.7	2.9	2.1
Chemicals and allied products	.5	.4	1.1
Rubber and plastics products	*	*	*
Leather and leather products	*	*	*
Stone, clay and glass products	.1	.1	.2
Primary metals	.2	.2	.2
Fabricated metals	1.3	1.6	1.3
Machinery, except electrical	.4	.7	.7
Electrical machinery	.1	.3	.2
Transportation equipment	.5	.6	.9
Miscellaneous and other	.4	.2	.5
Transportation, Communication and utilities	9.2	17.8	18.9
Trade	61.7	41.2	38.0
Wholesale	48.2	33.6	27.6
Retail	13.5	7.6	10.4
Finance	7.9	9.7	15.1
Services	5.5	10.9	13.5
Lodging	.7	1.4	1.1
Personal	.7	1.4	2.2
Business	2.6	5.1	5.4
Auto	.7	1.3	1.7
Recreation	.6	1.2	1.2
Other	.2	.5	1.9
Total	100.0	100.0	100.0

Note: Because of rounding, figures may not add to totals.

\*Less than 0.1 percent of tax base.

Source: See text.

unchanged under either levy, others would have their shares either doubled or halved, depending upon which tax was enacted. For example, the relative shares of chemicals and manufacturers of transportation equipment under a net income tax would double those of a gross receipts tax. On the other hand, the apparel industry's share would be approximately half as great under a net income tax.

San Francisco's industries naturally differ widely in the combinations of inputs they use. Some are comparatively labor-intensive while others are comparatively capital-intensive. A gross margins tax applies with equal weight to all factors of production, including labor, capital, and executive talent, in contrast to a net income tax, which is generally regarded as discriminatory against returns to equity capital. A tax on gross margins in San Francisco would likely distribute its impact according to the pattern shown in column (2) of Table 20. Compared to a gross receipts tax, a gross margins tax would reduce the shares of wholesaling and retailing, by 30 and 44 percent respectively, and increase the relative shares of all other major groups of business activity by as much as 98 percent (services).<sup>17</sup>

#### Tax Payments and Net Income

Although differential impact analysis is primarily concerned with analyzing the impact of alternative tax programs on tax patterns, the analysis can be extended to a consideration of the relationship between tax liabilities and other key economic variables. Table 21 gives a measure of tax "burden" for the major industry groups. The measure of burden used is the ratio of tax payments to net income under the alternative levies. This table was constructed by assuming that the City of San Francisco would collect \$25 million from the business community regardless of the type of levy employed or the required tax rate. On the basis of the estimated tax bases, tax rates under each levy have been calculated which would produce \$25 million. This yield would require a net income tax of 3.6 percent, a gross receipts tax of approximately \$2.00 per \$1,000 of receipts or a gross margins tax of 0.5 percent.

Table 21 indicates that the imposition of a net income tax rather than a gross receipts tax would result in a lesser "burden" for the construction and trade industries, while resulting in a greater "burden" for the transportation, communications, utilities, finance, and service industries. In aggregate, manufacturers would be indifferently affected, although we noted that within manufacturing the "burden" of several types of manufacturers would be substantially

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17. Within manufacturing there would be exceptions to this general trend. Some reordering of the relative shares would occur within manufacturing and a share of the tax base for some manufacturers would be less under a gross margins tax than a gross receipts tax.

TABLE 21

RATIOS OF TAX LIABILITIES TO NET INCOME BY TYPE OF TAX AND INDUSTRY  
FOR ALTERNATIVE EQUAL-YIELD TAXES<sup>a</sup>

	1	2	3
	Gross Receipts	Gross Margin	Net Income
	Tax	Tax	Tax
	(expressed as a percent of net income)		
Construction	5.0	9.1	3.6
Manufacturing	3.6	4.1	3.6
Food and kindred	5.4	4.7	3.6
Textile mill products	4.2	4.2	3.6
Apparel	6.2	8.8	3.6
Lumber and wood products	4.4	1.4	3.6
Furniture and fixtures	4.2	10.6	3.6
Paper and allied products	2.5	2.5	3.6
Printing and publishing	3.0	5.0	3.6
Chemicals and allied products	1.6	1.3	3.6
Rubber and plastics products	3.3	5.7	3.6
Leather and leather products	3.2	3.7	3.6
Stone, clay and glass products	1.6	1.6	3.6
Primary metals	3.9	3.9	3.6
Fabricated metals	3.7	4.5	3.6
Machinery, except electrical	2.0	3.5	3.6
Electrical machinery	2.3	7.0	3.6
Transportation equipment	1.9	2.3	3.6
Miscellaneous and other	2.7	1.3	3.6
Transportation, Communication and Utilities	1.7	3.4	3.6
Trade	5.8	3.9	3.6
Wholesale	6.3	4.4	3.6
Retail	4.7	2.6	3.6
Finance	1.9	2.3	3.6
Services	1.5	2.9	3.6
Lodging	2.3	4.5	3.6
Personal	1.1	2.3	3.6
Business	1.7	3.4	3.6
Auto	1.5	2.8	3.6
Recreation	1.9	3.7	3.6
Other	.4	1.0	3.6

a. Yield set at \$25 million for each levy.

Source: Computed from Table 20 and data underlying it.



different under each levy. Compared to a gross receipts tax, a tax on gross margins would result in a reduced burden only for the trade industries. Even so, we again note it would be preferred by some types of manufacturers.

## TWO SPECIAL BUSINESS TAXATION PROBLEMS

### The Commercial Occupancy Tax

#### Nature of the Impost

The Commercial Rent or Occupancy tax was initially considered along with the three imposts just discussed. It is a special hybrid species of impost, found only in New York City, levied on tenants of premises to be occupied or used for the purpose of carrying on or exercising any trade, business, profession, vocation or commercial activity. The measure of the occupancy tax is the rent or consideration paid for the use or occupancy of premises. In New York, a city noted for its prodigious concentration of office buildings and loft space, the tax now produces over \$70 million a year, and this figure is expected to reach \$100 million by the early 1970's due to sustained expansion of office space.

This levy is basically in the nature of a disguised real estate tax and attempts to accomplish what that tax cannot accomplish very easily: it differentially raises the real estate levy among the various classes of real estate and places the major burden of taxes upon commercial-industrial landlords. In places where it is undesirable to increase tax rates or change assessment ratios because of tax rate limits, state aid allocations, or political pressures, the occupancy tax is rather appealing as an expedient tax measure, particularly when supported by the notion that it is the occupants, not landlords per se, who are the ultimate payers of property taxes. New York City's occupancy tax has stood on its own since 1963, successfully resisting the onslaughts of critics who have denounced it as a covert and unfair increase in the real estate levy.

Because this tax, as imposed in New York City, is imposed on actual money rents but not the imputed rents paid by occupant landlords, its fairness is open to question. Yet even this major objection could be surmounted were a method employed that calculated imputed rents of owner-occupied office space. This discriminatory aspect of the New York tax is therefore not an intrinsic weakness of rent taxation in general.

There are several parallels between San Francisco and New York which constitute a basis for exploring the potential application of the occupancy tax in San Francisco. First, San Francisco, like New York, has a tenant-oriented



business rent roll. Second, both core cities have a disproportionate share of first-class office space in their environs. And third, pressure has been and is still being exerted to produce a de facto classified real estate tax roll which effectively taxes owner-occupied, single-family houses at a lower rate than commercial-industrial real estate. Because of these similarities, it is obligatory to review the commercial occupancy tax and discuss its potential desirability within the San Francisco context.

### Potential Yield

If a rent tax were imposed at the same rate as New York City's, 2.5 percent, the San Francisco commercial rent base would provide about \$3.8 million in tax collections.<sup>18</sup> This modest yield constitutes a relatively small pay-off for as highly visible a levy as the commercial rent tax. Furthermore, its administration might prove almost as expensive as some other taxes which yielded larger pay-offs. Assuming that the rent tax was handled through the assessor's office where the additional access to rent rolls might constitute some sort of marginal benefit to property tax administration, and collections were handled through normal channels, administrative expenses should not exceed 3 percent of gross collections, or about \$115,000.

### Incidence and Economic Effects

As in the incidence of other business taxes, the commercial occupancy tax may ultimately be paid by parties other than those legally liable. If a firm is in an advantageous market position, is able to "administer" prices, and faces little competition outside the city, it may be possible to pay the occupancy tax and then transmit the added cost of doing business to the firm's customers with little or no change in demand. It is reasonable to suppose that this is precisely what happens in New York City when a large, nation-wide corporation decides to move its headquarters to a desirable office building in New York City. Because demand for first-class office space in New York City has outstripped supply in recent years, tenants have been in a poor position to use the leverage of the occupancy tax to win lower rents from their landlords. At the same time the existence of older, less desirable office space in New York City is almost

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18. Based upon the ratio of commercial and industrial property value in San Francisco to its New York City counterpart.

certainly an omen of backward shifting of the tax from the tenant to the landlord of these premises.<sup>19</sup> It is also possible to conceive of situations where certain types of labor inputs, particularly those that may be less price elastic than others, would bear the brunt of a commercial occupancy tax. Such shifts could be realized where price and output remain constant, but where either the number of employees or their aggregate wage payments are reduced by the amount of the tax. No one at present can say with certainty to what degree a commercial occupancy tax would be shifted in San Francisco.

There are unquestionably firms with headquarters in San Francisco that would be in a position to shift a rent tax forward to their consumers via their entire state or nation-wide manufacturing and distribution systems. There are other firms that do not sell outside the city, are not locationally mobile (i.e., they are tied down to city's economic base), use scarce, highly skilled labor, and occupy office or loft space of the type which may be in short supply. Such firms will find themselves working with thinner profit margins. For a small number it may make the difference between a marginal existence and extinction. Other firms, particularly those of the footloose variety, will be able to move out from under this impost by moving to other locations in the Bay Area. Ample evidence exists to show that some manufacturing establishments have in the past relocated in the rest of the Bay Area and may continue to do so in the future. Less certain are the effects of a rent tax on those tenants which the city prizes most highly--headquarters operations and service-oriented businesses. The outlook for commercial office space in San Francisco provides an insight into this question. During the five-year period from 1960 through 1964, an unprecedented 3,500,000 square feet of office space was added to the San Francisco market. Smaller buildings contributed the majority of the space added, but larger buildings did account for approximately 25 percent of the added space. The large amount of space entering the market between 1960 and 1964 was well received. The major office buildings that were marketed during this period fared particularly well. Growing San Francisco firms were frequently unable to expand in their old buildings; they demanded more space and moved to new buildings that offered the needed space. Other smaller firms expanded and moved into the space these firms left behind. By May 1965 the advent of an additional 437,000 square feet of space raised the overall vacancy rate to approximately 4.8 percent from an average figure of about 4 percent for the 1960-64 period. Vacancies in large buildings also rose to 4.8 percent, though several buildings have rented additional space since May 1965. Thus, more new space was added to the San Francisco office inventory from 1960-64 than in any

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19. Stanley Lewis has pointed out that there are a number of conditions which may impede backward shifting of the tax in New York City. First, locations are not completely substitutable. Second, landlords may not reduce rents of particular tenants as they may then be forced to do so across the board; they will live with a higher vacancy rate as an alternative. Third, moving costs and costs associated with the disruption of business can offset the advantage of a lower rent. "All in all ... the commercial occupancy tax is probably not to any great extent shifted backward to landlords." cf. Stanley Lewis, "Effects of the Commercial Occupancy Tax," Financing Government in New York City, p. 587.

previous five-year period in the city's history. To date this space has rented very well, but the outlook for the future is less optimistic.

Recent Arthur D. Little, Inc., projections of the supply and demand of office space indicate that the current building boom may produce a vacancy rate in newly constructed office space as high as 24 percent by 1971. (See Table 22.) This startlingly high projection may be realized unless the city is able to attract new firms. Moreover, high vacancy percentages may reduce the annual rate of construction as investors see their rate of return tapering off. This in turn will have deleterious effects on wages paid to laborers, particularly the unskilled who live and work in San Francisco.

### A Poor Taxing Alternative

In the light of the present building boom, potentially higher vacancy rates, a possible downturn in construction activity, and a current drive to lure headquarters operations to San Francisco, a tax on commercial rents or space would appear wholly undesirable. A commercial occupancy tax would be shifted back to landlords in many cases although it certainly is possible to envisage the tenant bearing the burden of the tax for certain modern, well-situated office buildings. Backward shifting, coupled with high vacancy rates, could easily forestall a sustained period of construction activity and result in unemployment among those groups, the unskilled in particular, who already have the most limited job choices within the city. Despite the pressure of backward shifting of the tax under projected market conditions, the tax would be unpalatable to the new firms San Francisco is seeking to attract because decision-makers in most firms are concerned fundamentally with accounting, not economic costs. A tax bill which takes into account no measure of business activity or ability to pay will be viewed as another fixed cost of operating within San Francisco. This will be so even though implicit backward shifts would result in firms paying lower rent than they might otherwise pay. "Before and after" rent comparisons usually constitute inconclusive evidence of backward shifting, especially in those cases where the landlord refuses to make a formal concession to "pay" the tenant's occupancy tax. Therefore, it would seem that the commercial occupancy tax would bring the worst of all possible tax worlds to San Francisco by potentially causing harmful economic effects stemming from backward shifting and by forcing industry to foot the bill, if not the burden, of a highly visible tax.

### Bank Taxation

Finance is a major industry in the City of San Francisco. Of the almost 52,000 persons employed in the financial, insurance and real estate

TABLE 22

FORECAST OF TOTAL SAN FRANCISCO OFFICE SPACE ESTIMATED  
DEMAND AND SUPPLY 1966-1971

<u>Date</u>	<u>Estimated Total Square Feet of Available Office Space</u>	<u>Forecast of Total Square Feet of Occupied Space</u> (thousands)	<u>Estimated Vacancy Rate</u>
Dec. 31, 1966	19,865	18,160	8.6%
1967	20,710	18,720	9.6
1968	21,630	19,280	11.0
1969	23,440	19,840	15.0
1970	26,180	20,400	22.0
1971	27,880	20,960	24.0 <sup>a</sup>

a. This figure may be reduced if older buildings which will bear the brunt of the competitive condition are demolished or converted to other uses.

Source: Arthur D. Little, Inc., Financial and Market Analysis of Mixed Use  
Garage-Office Structure: A Report for the San Francisco Port Authority  
(December 30, 1966--mimeographed).

categories, more than 30,000, or about 60 percent, are working in banks and other lending institutions. Not only are the banks an important user of the City's and region's resources, but they are also important consumers of City-provided services. While special problems will always exist in allocating the proportion of a business tax base to banks, there is little theoretical justification for separate treatment of banks in City business taxation.

Equality or neutrality in business taxation dictates that equal or similarly situated firms be treated equally. While departures from this basic principle of "equal treatment of equals" may be justified and in certain instances even desirable, the burden of proving its desirability or necessity should be on its advocates. An example of such a departure would be a city's desire to encourage the maintenance or expansion of a particular industry within its boundaries. In the case of banking, there is little reason to believe that this is a locationally mobile ("footloose") industry. In any event, there is little theoretical justification for capricious tax liability differentials on the basis of differences in form rather than substance.

Even a cursory examination of the ways in which the City of San Francisco may tax banks indicates serious real legal limits on the City's ability to apply the principle of neutrality in business taxation. Federal statutes prescribe the types of taxes which may be imposed on federally chartered banks. These institutions may be subject to taxes on real estate, stockholders shares, net income and dividends. Taxes measured by gross receipts or value-added are thus inappropriate for the taxation of national banks. The State of California also limits the way in which localities may tax banks. The Bank Incorporation Tax Law (Part 11, Calif. Revenue and Taxation Code) imposes a tax which is based essentially on net income at a basic rate of 5.5 percent. Technically, this is a franchise tax on banks with the tax being measured by the net income of the preceding year. In addition to the 5.5 percent, there is an additional impost of up to 4 percent to make up for the fact that banks do not have to pay taxes on personal property. This additional percentage is equal to the percent of net income which business corporations pay as personal property taxes, and the maximum rate is applied to banks resulting in a total state income tax rate of 9.5 percent. The franchise tax on banks is in lieu of all other taxes and licences, state, county and local, except taxes on real property.

The franchise tax on financial corporations is imposed ostensibly to avoid discrimination between banks and financial corporations which are in competition with banks. Since these corporations are not exempt from personal property or license taxes, they are allowed a credit for such taxes paid, but their tax after application of the credit must not be less than 5.5 percent of net income or \$100, whichever is greater.

It has been argued that because banks with national charters enjoy immunity from most locally imposed business taxes, e.g., those measured by gross receipts, state-chartered institutions should also be immune from these same types of taxes. This does not seem to be a particularly plausible argument. If this degree of neutrality in business taxation were followed to its logical conclusion, there would be little left for the city to tax.

The State legislation requiring reassessment has important implications with respect to the imposition of the principle of neutrality of business taxation in San Francisco. Under the old system which effectively provided for a *de facto* business levy on real property, the Federal and State statutes did not restrict the application of the "equal treatment of equals" criterion. Under the new system, the banks, as well as other businesses, will receive a wind-fall resulting from the reassessment. Further, if the City chooses to re-establish the old balance of tax liability between the business community and the City's residential community by imposing a separate business levy, the banking sector is likely to receive preferential treatment.

It would seem that the avenues of recourse open to the City are limited. The most useful approach would be to request the elimination of the restrictive legislation imposed by the State. Then, if San Francisco chose to impose a net income tax, it would have assurance that the banking community would be required to pay its fair share in support of City services. If the City elected to enact a gross receipts or value-added tax, it would be advisable also to enact a net income tax as a minimum alternative. Under such a system a firm would compute its tax liability under both levies and pay the higher of the two. With a sufficiently low rate virtually all other businesses would be excluded from paying the net income tax.<sup>20</sup>

In summary, the forced reassessment of business property combined with the City's legal limitations on taxing banks under other alternatives, is likely to result in preferential tax treatment for banks. If the City attempts to recoup a part of the lost property tax revenue from the business community by imposing a separate business tax, departure from tax neutrality is likely to be compounded. San Francisco should attempt to have enabling legislation passed which would permit the City to tax banks on the basis of net income tax or as a minimum alternative to another levy.

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20. It is quite possible that high-markup, low-turnover firms would have net income tax liabilities exceeding their gross receipts or gross margin tax liability.

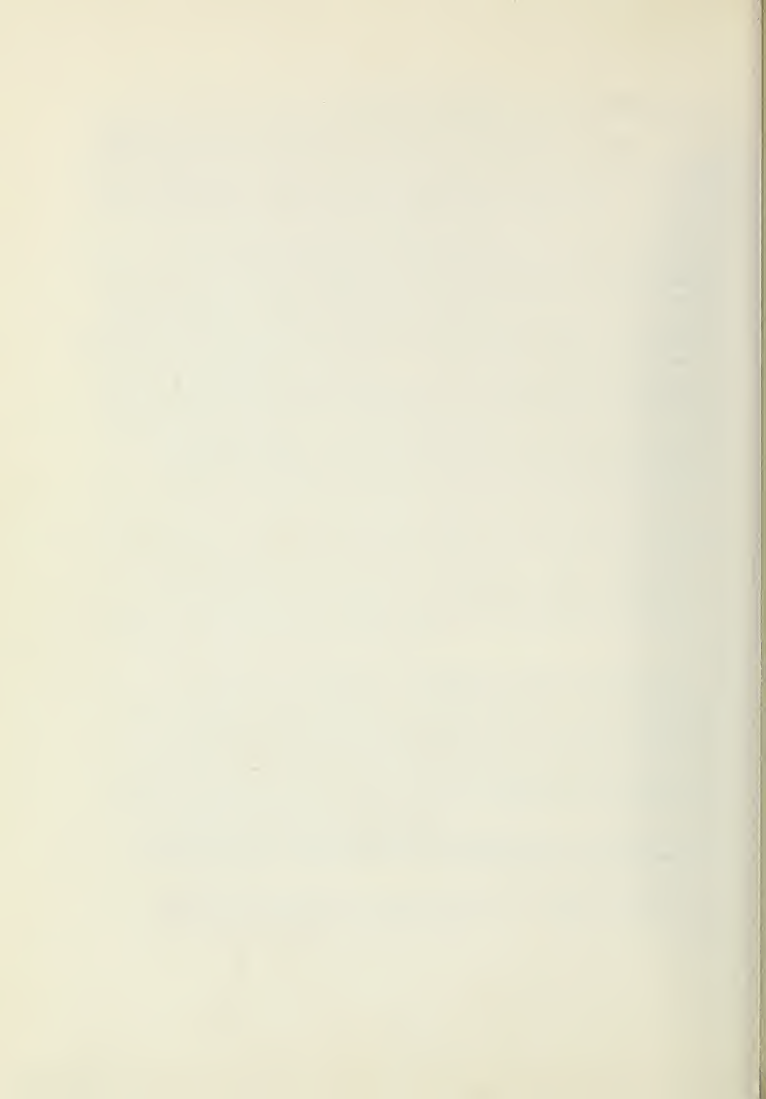
## CONCLUDING NOTE FOR BUSINESS TAXATION

Any tax applying only to business activities will result in a lowering of the property tax bill paid by the business community. This is a direct result of the way in which the property tax rate is set. The property tax rate is derived by dividing ratables into requirements. Since the required property tax yield is a residual amount computed after estimated "other" revenues have been deducted from estimated revenues, the required yield will quite obviously be decreased as other revenues are increased. Therefore, every additional dollar in taxes paid by the business community will lower property tax needs by the same amount.<sup>21</sup> After reassessment, commercial and industrial taxpayers will retain about 50 percent of total property tax liability.<sup>22</sup> A reduction of one dollar in property tax requirements will reduce the collective tax bills of commercial and industrial taxpayers by 50 cents. On balance, the business community's total tax bill will be increased by only 50 cents for every tax dollar paid in the form of a business activities tax. This finding is a significant one in that a \$25 million local business tax will result in residential homeowners and business property owners "splitting the difference" in their property taxes. --Business will recoup part of their business tax payments in the form of lower property tax bills.

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21. This analysis makes no attempt to comment on the argument that in the long run, additional sources of revenue will not lower property tax requirements because they escalate expenditure levels by the amount of the tax.

22. See Chapter I, Table 6.





## CHAPTER V

### MUNICIPAL PERSONAL INCOME TAX

An income tax offers an attractive opportunity to achieve several important public policy objectives simultaneously. First, the City may solve its current pressing need for additional revenue. Second, the City may introduce into its system of taxation a major tax which recognizes families' ability-to-pay as an important criterion in allocating the tax burden. Third, the income tax is a "growth" tax. Revenues will grow at the same rate as, or even faster than, the City and/or the region. Fourth, the effects of this type of impost would not be as deleterious to the commercial and industrial development of the City as would alternative taxation modes'. And, fifth, an adroitly drawn income tax in San Francisco could become the keystone of a series of Bay Area income taxes interlocking in such a way that collectively they would constitute an effective surrogate for a major regional impost.

#### CURRENT USE

Beginning with its imposition in Philadelphia in 1949, the municipal income tax has been extended to hundreds of local government units, including 12 cities of over 300,000 population and 33 with populations over 50,000.

Table 23 illustrates the breadth of application of this tax at present. Many cities, including Lexington, Louisville, Toledo, and Philadelphia, rely on income taxation to provide from 40 to 70 percent of their tax revenues. Interestingly, most cities that do levy a municipal income tax are able to count on it to provide major portions of their revenue and tax needs despite rate structures that not only are set extremely low, but also are simple and nongraduated as well. The range of rates exhibited by American cities lies between 0.25 percent and 2 percent, with the vast majority imposing a 1 percent rate. The experience of recent years strongly suggests that income taxes are becoming more popular at the local level; e.g., in Pennsylvania there are presently 1183 personal income taxes, many of which are shared by coterminous tax units.

It is not uncommon for communities levying personal income taxes also to apply a similar impost to the income of unincorporated businesses and corporations. Thus net profits of professions and unincorporated businesses, and in some cases corporations (e.g., Ohio cities, Kentucky cities, New York, and St. Louis) will fall into the web of local taxation. Implementation of income taxation at the local level for corporations and business operations, is substantially more difficult since the locus of business income generation is open



to more dispute than is that for individual income, providing that investment income is exempt from local taxation. Because of this, local income taxation of individuals has been more popular and easier to administer than has income taxation of local businesses, unincorporated or incorporated.

### YIELD

Among the larger cities, there are essentially four approaches to the question of what income should be taxed. The most narrow approach is that used by the City of Louisville which subjects residents and commuters to a flat-rate tax on income earned within the City, exempting all unearned income and any income of residents and commuters earned outside of the city limits. Since no personal exemptions are allowed, this type of tax should perhaps more accurately be called a payroll tax. This shall be identified as a Type I income tax.

Were such a tax instituted in San Francisco, taxable income would amount to about \$3.2 billion dollars in 1967. (See Table 24.) If deductions and exemptions were allowed, this base could shrink to as little as \$1.1 billion, the latter figure representing taxable income after exemptions and deductions similar to those allowed under the California income tax.

Type II, as characterized by the Philadelphia tax, differs from Louisville formula in only one respect aside from the tax rate. Philadelphia taxes all earned income of residents, whatever the source, and, like Louisville, taxes only the income that commuters earn within the city. Again, no personal exemptions or deductions are allowed; consequently, the levy could be termed a modified payroll tax. Under this formula, the income tax base for San Francisco would rise to about \$3.5 billion and, with exemptions and deductions, could be reduced to as little as \$1.3 billion.

The uniform Michigan tax, used in Detroit and four other large cities, is broader than the first two in that it taxes at a flat rate the property income of residents as well as all earned income. Non-residents are taxed as in Louisville and Philadelphia. Another significant difference is the allowance of a \$600 personal and dependency exemption. The broad coverage and exemption allowance make the Michigan tax close in form to the typical state tax, with the major exception that the latter usually provides for graduated rates. Under this formula, the San Francisco tax base would be about \$4.1 billion without the \$600 per capita exemption and \$3.2 billion with it. Under this Type III scheme, the smallest tax base for San Francisco would be about \$1.6 billion if States exemptions and deductions were allowed.

**TABLE 23 -- MUNICIPAL INCOME TAXES, RATES AND COLLECTIONS**  
(dollar amounts in thousands)

State and Municipality	Rate January 1, 1967 (percent)	Municipal tax collections, 1964-65 (Cities with over 50,000 population in 1960)		
		Total tax collections	Income tax collections	
			Amount	As a percent of total collections
<u>Alabama:</u>				
Gadsden	2.0	\$ 3,699	\$ 1,895	51.2
<u>Kentucky:</u>				
Berea	1.0	xxx	xxx	xxx
Catlettsburg	1.0	xxx	xxx	xxx
Covington	1.5	2,742	773	28.2
Flemingsburg	0.5	xxx	xxx	xxx
Frankfort	1.0	xxx	xxx	xxx
Hopkinsville	1.0	xxx	xxx	xxx
Lexington	1.5	6,186	3,166	51.2
Louisville	1.25	25,556	12,794	50.1
Jefferson County <sup>1/</sup>	1.75	xxx	xxx	xxx
Ludlow	1.0	xxx	xxx	xxx
Mayfield	0.67	xxx	xxx	xxx
Maysville	1.0	xxx	xxx	xxx
Newport	2.0	xxx	xxx	xxx
Owensboro	1.0	xxx	xxx	xxx
Paducah	1.0	xxx	xxx	xxx
Pikeville	1.0	xxx	xxx	xxx
Princeton	1.0	xxx	xxx	xxx
<u>Maryland:</u>				
Baltimore City	1.0 <sup>2/</sup>	134,677	3/	3/
Montgomery County	1.0	xxx	xxx	xxx
Caroline County	1.0	xxx	xxx	xxx
Howard County	1.0	xxx	xxx	xxx
<u>Michigan:</u>				
Detroit	4/	160,428	43,996	27.4
Flint	4/	11,470	2,269 <sup>2/</sup>	19.8
Highland Park	4/	xxx	xxx	xxx
Hamtramck	4/	xxx	xxx	xxx
Lapeer	4/	xxx	xxx	xxx
Saginaw	4/	4,666	3/	3/
<u>Missouri:</u>				
Kansas City	0.5	40,154	8,992	22.4
St. Louis	1.0	75,890	24,145	31.8
<u>New York:</u>				
New York City	0.4-2.0 <sup>6/</sup>	2,225,120	3/	3/
<u>Ohio:</u>				
Cities, 50,000 population and over--				
Akron	1.0	19,748	8,803	44.6
Canton	1.0	5,082	3,585	70.5
Cincinnati	1.0	43,681	16,453	37.7
Columbus	1.0	21,459	14,747	68.7
Dayton	1.0	18,586	8,887	47.8
Hamilton	1.0	2,598	1,314	50.6
Lima	0.75	1,715	1,056	61.6
Springfield	1.0	3,443	2,286	66.4
Toledo	1.0	17,972	9,780	54.4
Warren	1.0	2,565	1,883	73.4
Youngstown	1.0	8,150	4,179	51.3
94 cities and villages (with less than 50,000 population)	0.25-1.0	xxx	xxx	xxx

See footnotes at the end of table.

TABLE 23 (Continued)

State and Municipality	Rate January 1, 1967 (percent)	Municipal tax collections, 1964-65 (Cities with over 50,000 population in 1960)		
		Total tax collections	Income tax collections	
			Amount	As a percent of total collections
<u>Pennsylvania:</u>				
Cities, 50,000 population and over--				
Allentown	1.0 <sup>7</sup> / <sub>8</sub>	\$ 4,704	\$ 1,116	23.7
Altoona	1.0 <sup>7</sup> / <sub>8</sub>	2,257	462	20.5
Bethlehem	1.0 <sup>7</sup> / <sub>8</sub>	3,613	860	23.8
Chester	1.0 <sup>7</sup> / <sub>8</sub>	2,305	3/	3/
Erie	1.0 <sup>7</sup> / <sub>8</sub>	5,873	1,139	19.4
Harrisburg	1.0 <sup>7</sup> / <sub>8</sub>	3,355	3/	3/
Johnstown	1.0 <sup>7</sup> / <sub>8</sub>	2,120	362	17.1
Lancaster	0.5 <sup>10</sup> / <sub>16</sub>	2,051	473	23.1
Penn Hills Township	1.0 <sup>7</sup> / <sub>8</sub>	1,464	576	39.3
Philadelphia	2.0 <sup>7</sup> / <sub>8</sub>	210,881	85,967	40.8
Pittsburgh	1.0 <sup>7</sup> / <sub>8</sub>	49,535	9,817	19.8
Scranton	0.5 <sup>7</sup> / <sub>8</sub>	4,149	668	16.1
York	1.0 <sup>7</sup> / <sub>8</sub>	1,925	3/	3/
Approx. 30 other cities, 450 boroughs, 430 townships, and 1,070 school districts.	0.25-1.5 <sup>11</sup> / <sub>16</sub>	xxx	xxx	xxx

Note: Excludes Washington, D. C. which has a graduated net income tax that is more closely akin to a State tax than to the municipal income taxes (see table 53).

"xxx" Signifies cities under 50,000 population.

- 1/ A taxpayer subject to the 1.25 percent tax imposed by the City of Louisville may credit this tax against the 1.75 percent tax levied by Jefferson County.
- 2/ The rate for residents is 1.0 percent, nonresidents 0.5 percent.
- 3/ Tax went into effect after reporting period.
- 4/ Under the Michigan "Uniform City Income Tax Act," the prescribed rates are 1.0 percent for residents and 0.5 percent for nonresidents. A resident is allowed credit for taxes paid to another city as a nonresident.
- 5/ Partial year collections. The Flint tax was repealed on July 21, 1964 and re-enacted, effective January 1, 1965, under the Michigan "Uniform City Income Tax Act." Data are for fiscal year ending June 30, 1965.
- 6/ New York City residents' rate ranges from 0.4 percent on taxable income of less than \$1,000 to 2.0 percent on taxable income in excess of \$30,000. An earnings tax of 0.25 percent of wages or 3/8 of 1 percent on net earnings from self-employment, not to exceed that which would be due if taxpayer were a resident, is levied against nonresidents.
- 7/ The school district rate is the same as the municipal rate.
- 8/ The school district rate is 0.5 percent.
- 9/ There is no school district income tax.
- 10/ The school district rate is 1.0 percent.
- 11/ Enabling act maximum rate is 1.0 percent but the Township of German (1.5 percent) and Borough of Westover (1.25 percent) levy higher rates as distressed school districts by authority of Sec. 649 Public School Code. A separate enabling act applies to Philadelphia.

Source: Reproduced from Advisory Commission on Intergovernmental Relations.  
Tax Overlapping in the United States: Selected Tables Updated (January  
 1, 1967), Table 59 (pp. 36-37).

TABLE 24

YIELD OF ONE PERCENT TAX ON ALTERNATIVE BASES

1967

<u>Type of Tax</u>	<u>Yield</u> (thousands)
<u>Type I - Tax on income earned in San Francisco</u>	
A. A.G.I. (Adjusted Gross Income)	\$32,000
B. A.G.I. less \$600 per capita deduction	24,650
C. A.G.I. less State deduction	15,800
D. Federal tax base	19,520
E. California tax base	10,670
<u>Type II - Tax on all earned income of San Francisco residents and on commuter earnings in San Francisco</u>	
A. A.G.I.	\$35,460
B. A.G.I. less \$600 per capita deduction	27,310
C. A.G.I. less State deduction	18,460
D. Federal tax base	21,630
E. California tax base	12,780
<u>Type III - Tax on total income of San Francisco residents and commuter earnings in San Francisco</u>	
A. A.G.I.	\$40,600
B. A.G.I. less \$600 per capita deduction	31,270
C. A.G.I. less State deduction	22,420
D. Federal tax base	24,770
E. California tax base	15,920

Source: Appendix C of this report.

The fourth type, that instituted by New York City in 1966, has the same income base as the Michigan tax, i.e., all income of residents and income earned by commuters in New York City. But it differs in several other important respects. First, the income base and rates are computed separately for residents and for commuters. The former are taxed on the state income tax base, which is essentially Federal taxable income. Consequently, they receive the benefit of \$600 exemptions and normal deductions. The rate is graduated, ranging from 0.4 percent on income under \$1,000 to 2 percent on income over \$30,000. This part of the tax is similar to most state income taxes. Except for rates, it is identical to the New York State system.

Commuters, on the other hand, are subject to a payroll tax only on income earned within the City or, if self-employed, to a tax on net earnings. From gross earned income, taxpayers subtract an exclusion of \$3,000 if total wages or net earnings are under \$10,000; \$2,000 if between \$10,000 and \$20,000; \$1,000 if between \$20,000 and \$30,000. No exclusion is allowed if total income is more than \$30,000. Taxable income, thus calculated, is then taxed at the flat rate of three-eighths of one percent.

No computations have been made for San Francisco under this method. There seems to be no advantage in providing an entirely different tax system for non-residents. If it is desired to ease or more equitably allocate their relative burden, this can be done by adjusting the base or the tax rates. An entirely separate computation leads to unnecessary administrative complications.

The cost of administering a local income tax should be low in proportion to total yields. Withholding will insure a high degree of compliance for most taxpayers at modest cost to the taxing authorities. Not more than about 1.5 percent of total collections will be needed to administer such a tax with reasonable effectiveness.

#### INCIDENCE AND EFFECTS

Ordinarily the burden of income taxation cannot be shifted from those who are legally bound to pay the tax to any other group, mainly for want of market relationships. One may, however, conceive of a situation within a regional or Bay Area context, wherein the supply of commuting labor could be decreased in San Francisco to the extent that alternative employment opportunities exist outside the City. Upon closer inspection, however, this theoretical objection to local income taxation does not seem valid. The bulk of commuters to San Francisco are restricted in their employment alternatives. San Francisco is continuing to receive the major portion of the high-income office jobs being created within the region. There are many reasons why this is so and why San Francisco should continue to be the type of city which attracts headquarters

operations. It offers the greatest opportunities for face-to-face business contacts, the most congenial and urbane atmosphere in which to make important business decisions, the highest concentration of external economies such as those provided by printing, advertising, publishing and material supply centers, and by far the largest amount of first-class office space. Furthermore, it is entirely possible that many of the firms in question would be in a market position to partially compensate labor, should the need arise, without affecting profit margins (i.e., they could shift higher wages forward in the form of higher prices). Although this entire rebuttal is wholly speculative since no one really knows very much about the market position of these firms, it is more tenable than the initial argument that the income tax would be shifted backward to the owners of other factors (land, labor, and capital).

In order to illustrate the effect of a flat-rate income tax on families in San Francisco, we have determined how a hypothetical flat-rate, 1 percent income tax could be distributed among the City's families arrayed by adjusted gross income class.<sup>1</sup> No matter which tax base is chosen, a flat-rate income tax will be a progressive tax provided a sizable exemption is included. (See Tables 25-27 and Figure 4.) This finding is an important one and is frequently misunderstood. The price of misunderstanding can be either an unwieldy income tax like New York City's, or even a stalemate over a decision to introduce any new tax. Of course, it is true that as the income base is narrowed to the point where it becomes a true "payroll" or salary and wages tax, the exemption must be enlarged somewhat to compensate for the fact that as family income decreases, wages and salaries become a relatively larger component of total income. But this phenomenon should not divert attention from the essential truth that large exemptions such as those provided under Federal or California income tax law introduce a mild progressive bias to the effective rate schedule.

Another possible misperception of Tables 25 to 27 would lead one to conclude that although exemptions coupled to a flat rate really do provide a progressive effective rate schedule, the "progressiveness" (i.s., the ability of a tax to increase more rapidly than income as income rises) begins to drop off and flatten out in the highest brackets. This may be so, but one must recognize that the number of returns filed in incomes of over \$20,000 internal is relatively quite small -- only slightly more than 2 percent of all returns filed in the City. The fact that the tax "flattens out" for a very small minority and the pinnacle of the income scale does not constitute insufficient reason to call the flat-rate tax with exemption anything other than a progressive tax.<sup>2</sup>

1. Because of the lack of detail concerning the components of income, e.g., wages and salaries for each income class, no attempt was made to portray the incidence of Type I and Type II income taxes.
2. Due to problems of definition of income and other legal problems in the highest brackets, it is probably best left to the Federal authorities to extract as much revenue as may be found desirable by imposing progressive rate schedules in this "income stratosphere."



TABLE 25

HYPOTHETICAL FLAT-RATE CITY INCOME TAX (TYPE III) ON A  
MARRIED COUPLE WITH TWO CHILDREN, FEDERAL TAX BASE

Adjusted Gross Income (A.G.I.)	Exemptions	Deductions <sup>a</sup>	Taxable Income	Hypothetical City Tax	
				At 1 Percent Rate	As percent of A.G.I.
\$ 4,000	\$2,400	\$ 400	\$ 1,200	\$ 12	0.38
5,000	2,400	500	2,100	21	0.42
6,000	2,400	600	3,000	30	0.50
8,000	2,400	800	4,800	48	0.60
10,000	2,400	1,000	6,600	66	0.66
15,000	2,400	1,600	11,000	110	0.73
20,000	2,400	2,200	15,400	154	0.77
25,000	2,400	2,900	19,700	197	0.79

a. Assumes 10 percent standard deduction for income up to \$10,000 and slightly larger proportionate itemized deductions above \$10,000.

TABLE 26

HYPOTHETICAL FLAT-RATE CITY INCOME TAX (TYPE III) ON A  
MARRIED COUPLE WITH TWO CHILDREN, CALIFORNIA TAX BASE

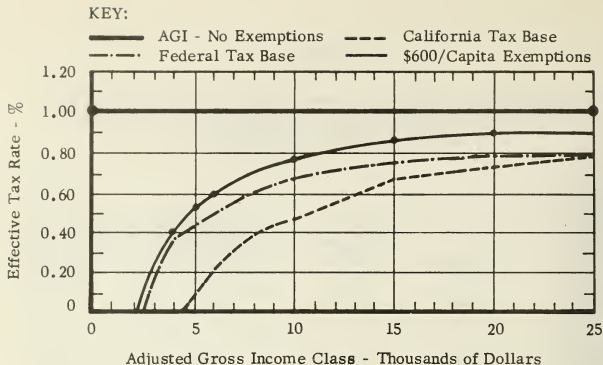
Adjusted Gross Income (A.G.I.)	<u>Exemptions</u>	<u>Deductions</u> <sup>a</sup>	<u>Taxable Income</u>	<u>Hypothetical City Tax</u>	
				<u>At 1 Percent Rate</u>	<u>As Percent of A.G.I.</u>
\$ 4,000	\$4,200	\$ 400	\$ -	\$ -	.00
5,000	4,200	500	300	3	.06
6,000	4,200	600	1,200	12	.20
8,000	4,200	800	3,000	30	.38
10,000	4,200	1,000	4,800	48	.48
15,000	4,200	1,000	9,800	98	.65
20,000	4,200	1,000	14,800	148	.74
25,000	4,200	1,000	19,800	198	.79

a. Assumes 10 percent standard deduction for incomes up to \$10,000.

TABLE 27

HYPOTHETICAL FLAT-RATE CITY INCOME TAX (TYPE III) ON A  
MARRIED COUPLE WITH TWO CHILDREN,  
\$600 PER CAPITA EXEMPTIONS

Adjusted Gross Income (A.G.I.)	<u>Exemptions</u>	<u>Taxable Income</u>	<u>Hypothetical City Tax</u>	
			<u>At 1 Percent Rate</u>	<u>As Percent of A.G.I.</u>
\$ 4,000	\$2,400	\$ 1,600	\$ 16	.40
5,000	2,400	2,600	26	.52
6,000	2,400	3,600	36	.60
8,000	2,400	5,600	56	.70
10,000	2,400	7,600	76	.76
15,000	2,400	12,600	126	.84
20,000	2,400	17,600	176	.88
25,000	2,400	22,600	226	.90



\*Base taxes all earned income and property income of residents and income of non-residents earned in city.

Source: Tables 25-27

FIGURE 4 BURDEN OF HYPOTHETICAL CITY FLAT-RATE INCOME TAX\* ON A MARRIED COUPLE WITH TWO CHILDREN

The potential flexibility of this type of levy is illustrated particularly well by Table 26 where the California tax base is utilized. The liberal granting of exemptions plus deductions insures that anyone with adjusted gross income under \$4,600 will pay no tax. Despite this loss of tax base, tax so imposed could still bring in nearly \$16 million in revenue if levied on commuters as well. This rate schedule would be relatively innocuous for a large majority of the City's residents, especially those earning under \$10,000 a year whose payments equalling less than half a percent of their earnings would be extracted from their paychecks.<sup>3</sup>

3. There is both an advantage and a disadvantage to using the California base. The advantage lies in creating a climate of comparability with the State impost; this could pave the way for a surtax to be collected by the State for the City or for a regional tax which is discussed in the next section of the text. The disadvantage is that the tax will never become the real revenue producer, at least at a low rate, that a broader tax (i.e., a tax based on Federal adjusted gross income) would.

## GROWTH

A flat-rate, municipal income tax will grow at a rate slightly exceeding that of the local economy. This is one of the outstanding advantages of income taxation as contrasted with property taxation, which may normally be expected to lag somewhat behind economic activity. Even though a municipal income tax would be imposed at a flat rate, the existence of exemptions would introduce some progression, however mild, and would insure a high degree of revenue elasticity. Needless to say, a steeply graduated rate would be one device which could guarantee a very elastic tax base. However, such a rate structure is clearly beyond the scope of local taxation.

## A REGION-WIDE IMPOST

A locally imposed income tax could be the precursor either to harmonious fiscal relationships or to a higher degree of conflict within the region. If San Francisco were to decide that it should extract the maximum amount of revenue from residents and commuters alike, it is possible to envisage other cities in the Bay Area obtaining the right to impose an earnings of income tax of their own and then proceeding to tax the resident of San Francisco who is working in that city. This is a very long run possibility, but it is doubtful that San Franciscans would tolerate taxation of their incomes both in the City of their residence and the City where they work, and the law would undoubtedly then be altered by San Francisco to allow a tax credit for income taxes paid elsewhere. In order to forestall the acrimonious dialogue that would undoubtedly ensue should other communities levy an income tax designed to tax their commuters, it would be in the City's interest to write a law which would automatically grant a credit to its own residents for taxes paid to any other locality.

A tax credit allowed for other Bay Area income taxes could result in some reduction in tax yield for San Francisco, since some 44,500 out-commuters live in San Francisco. However, it will be some time before other Bay Area communities receive authorization to levy payroll taxes even should San Francisco proceed to do so, and it is thus reasonable to suppose that San Francisco out-commuters will be paying their taxes to the City for at least the next few years. In any event, there are over 106,000 in-commuters whose income tax payments will more than offset any potential "losses" attributable to tax credits for San Francisco's out-commuters. These in-commuters are not only more numerous, but their incomes average about 50 percent higher than those of the less affluent out-commuting group.

It may be argued that under such a tax crediting scheme the contribution to San Francisco City Government made by in-commuters will always exceed

the contribution made by San Francisco's out-commuters to the operation of government in the rest of the Bay Area because of a net favorable balance of commuters in San Francisco. This objection ignores the balance of essential functions which San Francisco performs for the rest of the region. San Francisco is the "core" of the Bay Area and carries on cultural, recreational, and promotional activities that benefit everyone in the region. The California Academy of Sciences, the Symphony, the M.H. de Young Memorial Museum, the California Palace of the Legion of Honor, the Fleishacker Zoo, and even that venerable and costly contrivance, the cable car, are all maintained and priced "below cost" by San Francisco for the benefit of everyone. This argument can easily be extended to other important urban functions including police protection and street cleaning. The important point is that it is in the very nature of a City like San Francisco to generate a number of public services that cannot be duplicated anywhere else in the region and whose benefits flow to everyone irrespective of residence. To lightly tax those commuters who spend a large portion of their day in such a City does not seem to be inequitable. The fact that in the aggregate, tax payments of San Franciscans commuting out to Bay Area destinations do not equal those made by in-commuters seems patently irrelevant when considering the level of benefits received by these same in-commuters.

#### LONG-RUN INCOME TAX GOAL

If San Francisco levies an income tax, the State will undoubtedly be put under pressure to grant other political jurisdictions the right to level payroll or earning taxes. Moreover, the State may be the only political entity which can arbitrate possible disputes and conflicts which may arise in connection with these imposts. If the State were to step into the picture either by allowing municipalities to levy a surtax on the state income tax or by developing some sort of innovative formula which could resolve disputes over the primacy of either residence or work sites as the basis for local income taxation, local non-property taxation could take a giant step forward in California. In short, San Francisco cannot be expected to single-handedly resolve Bay Area fiscal problems or harmonize its tax structure. What it can do is levy a fair and flexible earnings tax which will tax commuters and residents at the same rate provided residents are paying no other municipal income taxes. And this tax, in the jargon of the economist, would effectively bring a significant portion of San Francisco's externalities or spillovers within the scope of the City's network of taxation.

#### WOULD THE HOMEOWNER BE BETTER OFF WITH AN INCOME TAX?

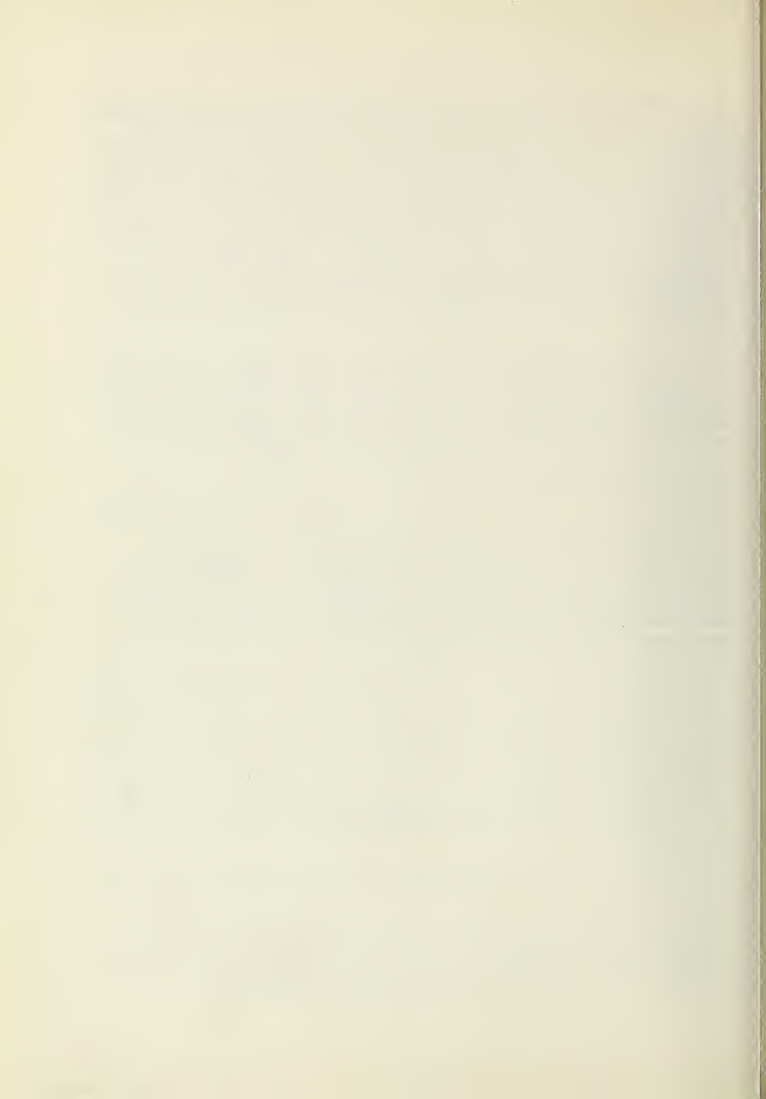
Because the homeowner will be particularly hard-hit by reassessment, he may wonder, "If I support an individual income tax, will I be better off than I would be if I simply paid higher property taxes?" The answer, probably, is yes.

Property and current income are not identically distributed among the population. A person with a high personal income tax liability may have a relatively low property tax liability. This follows from the previously observed inelasticity of housing expenditures. However, there is another, more specific way of looking at the problem. Take a hypothetical homeowner who earns (has an adjusted gross income of) \$10,000 a year. Assume further that his home has a market value of \$40,000 and will now be assessed at 25 percent of market value. The total tax payment of this individual would be \$890, given an \$8.90 per hundred tax rate. If he were to pay an earnings tax of 1 percent of his Federal taxable income, his property tax bill could be lowered by as much as \$110 while his income tax bill would be somewhere in the neighborhood of \$66.<sup>4</sup> He would be \$45 better off.

It is apparent that if one is interested in correcting the shift problem previously outlined, taxation of individual income is not a device which focuses on the problem as finely as does business taxation. On the other hand, income taxes deal with the problem created by benefit spillovers to non-resident beneficiaries more directly than does business taxation. In order to insure, therefore, that a maximum number of City families will be "better off" after the imposition of an income tax it is imperative that the tax consider non-resident earnings in the base. However, it is certainly possible to envisage some homeowners paying more due to a supplementary income tax. The people who would be "worse off" would be those who have extremely low house-value/income ratios and who live in older, underassessed dwelling units. Further, it is undoubtedly true that the lowest house-value/income ratios occur in the highest income ranges. Thus, the greatest number of people who will be "worse off" from a combined tax standpoint after imposition of an individual income tax will be those in the highest income ranges.

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4. Computation (Type III) assumes family of four and application of standard deduction.





## CHAPTER VI

### OTHER NON-PROPERTY TAX ALTERNATIVES

#### HOTEL ROOM TAX

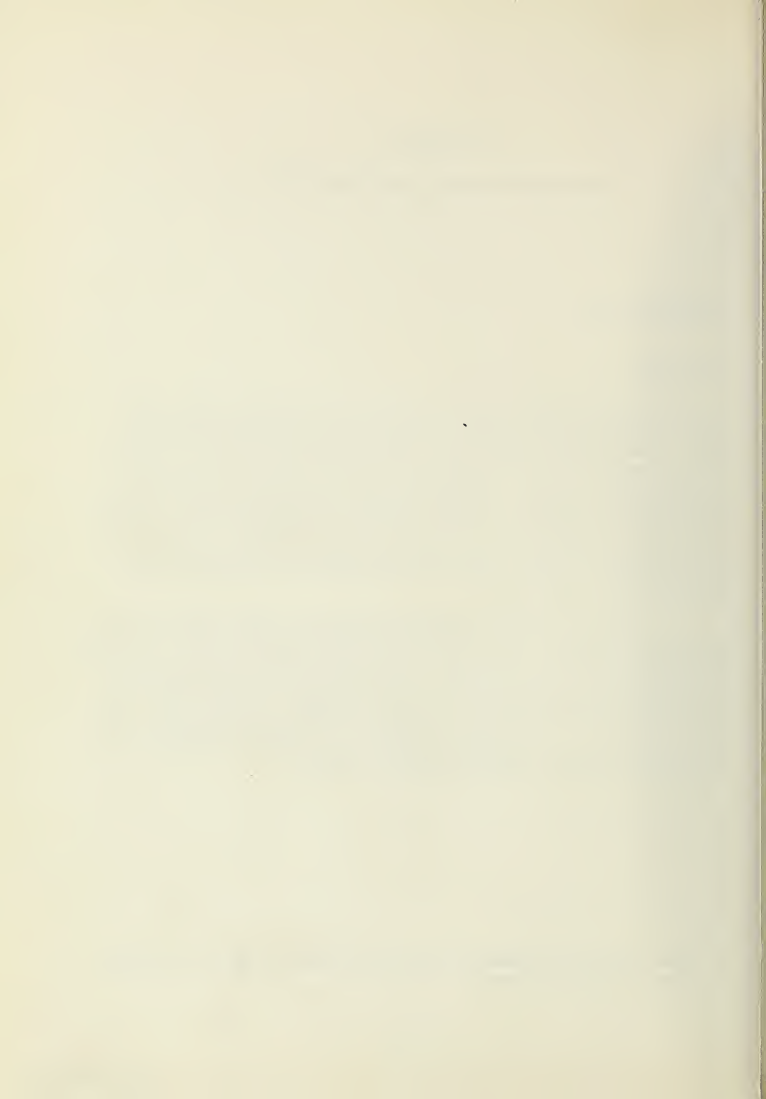
##### Background

A 3-percent tax on transient hotel-motel occupancy charges is currently imposed in San Francisco. The tax was first levied during fiscal year 1962. It was principally justified as a means of providing supplementary funds for the promotion of the City as a tourist attraction and for the general enriching of the cultural climate. The tourist was seen as the primary beneficiary of this additional expenditure, so it was felt that he should be required to make this rather small contribution to these enlarged promotional efforts. Proponents of the tax believed that the low rate of the tax, combined with the unique attractiveness of the City to tourists, would more than offset any possible undesirable effects on tourist expenditures.

Time has thoroughly vindicated this appraisal of the impact of the tax on the tourist industry. Total visitor dollars spent in San Francisco rose unabated during the period extending from the years immediately prior to imposition of the tax through the years following it. Thus, there was no visible impact of the tax on tourist-related industries. As tourism has grown, so has the tax. While still a small tax, the hotel-motel tax brought in over \$1.6 million in 1966, and with the same rates as at present, may produce as much as \$3.7 million by 1975 if a recent projection of convention activity is realized.<sup>1</sup>

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1. Leslie C. Peacock, "The Economics of Conventions," San Francisco Convention and Visitors Bureau, February 14, 1966, (mimeographed.)



Total visitor expenditures were as follows:

1960	\$90,454.4	(thousands)
1961	102,782.8	
1962	111,814.6	
1963	117,436.4	
1964	149,182.4	
1965	178,006.0 <sup>a</sup>	
1966	201,475.0 <sup>a</sup>	

a. Not strictly comparable with preceding figures.

Source: Convention and Visitors Bureau

Since 1963, when the state legislature authorized general law cities and counties to enact a hotel room tax, several have levied a 4 percent rate, the same rate as that imposed by the combined state and local retail sales tax.

The tax is essentially a tax on transients, not residents of hotels. The base is the amount of the hotel bill and the tax is shown as a separate item. The legal incidence is clearly on the consumer of hotel space, and so, most likely is the economic incidence.

#### Incidence

It is difficult to visualize the consumer-tourist being able to shift the tax backwards. It is well-known that the City of San Francisco offers a series of unique convention and visitor facilities, most of which cannot be easily duplicated in the rest of the nation or the rest of the Bay Area. All evidence shows that hotel room rates, number of hotel rooms, number of visitors and visitor expenditures have all moved forward almost in lock-step over the past few years. Moreover, the tourist is now conditioned by such a web of state and local sales taxes that he finds a small addition to his hotel bill hardly surprising.

There is one rather obvious aspect of this tax which bears mentioning. Most hotel-motel occupants do not live in San Francisco or even the Bay Area.

Therefore, the burden of taxation, if we consider the tax to be entirely forward shifted, falls outside of the city. This point is significant in that tourists do use large quantities of public services for which they pay very little (e.g., police and fire protection and public transportation). It has been argued that tourists bring extra dollars into the city's economy and that special efforts should be made to attract them. That tourism is important to the City's economy and that the City should attract tourists is without question. It is fallacious, however, to think that public services should be provided "free" (paid for by city taxpayers) or at a price significantly less than cost (e.g., the cable car). No one would suggest that private goods and services be sold to tourists at less than cost to insure their continued visits; no one has suggested that the price of chop suey remain at the 1940 level because it results in a stream of indirect benefits that outweigh the amount of the "subsidy". But this is precisely the argument which is sometimes offered regarding the treatment of tourists who require goods and services produced by the public rather than the private sector. For these reasons the existence of a small hotel tax paid for by tourists seems entirely equitable and desirable.

### Potential Yield

There are reasons to suppose that the City is not exploiting the tax as fully as it might. New York City has a 5 percent hotel room tax; some California communities have a 4 percent levy, and the combined California-San Francisco sales tax stands at 4 percent. Thus, there is ample precedent for increasing the tax. By adjusting the Peacock projection<sup>2</sup> of revenue from this source, the following yields could be realized:

Fiscal Year	Yield @ 3%	Yield @ 4%	Yield @ 5%
1967 - 68	\$1,913,500	\$2,558,499	\$3,203,498
1968 - 69	2,104,800	2,806,399	3,507,998

By raising the rate only 1 percent, the tax would bring in nearly \$644,999 in additional revenue. A 2 percent tax increase would result in over one million dollars additional new funds.

2. Peacock, op. cit.

## Policy

Increasing the 3 percent hotel-motel tax to 5 percent seems equitable and economically justifiable. Claims that this tax has been a burden to the hotel-motel industry or to tourist-oriented businesses do not square with the facts. Not only could the City realize more than an additional million dollars a year in revenue, but it would also extract this revenue from tourists, who really do not pay directly for what they receive in terms of public services and who do not fall within the City's property tax web. This argument is particularly compelling in light of the City's long-established policy to subsidize museums, zoos, the emergency hospital, transit, etc. The tourist takes advantages of a large portion of the services so provided; it is eminently fair that a means such as the hotel-motel tax be found to insure that he at least makes a minimal contribution to their financing.

## REAL ESTATE TRANSFER TAX

### The Federal Impost

On January 1, 1968, the Federal government will probably eliminate its documentary stamp tax on the transfer of equity in real estate. In response to this action, San Francisco has an opportunity to move into this field of taxation, provided the state does not pass pre-emptive legislation of its own during the current legislative session. The Federal impost is levied at a rate of 11/100 of 1 percent (55 cents on each \$500) of the net consideration paid for, or the net value of, the realty conveyed. The base consists of the deeds, instruments, or other writings whereby realty sold is granted, assigned, transferred, conveyed, etc., to the purchaser or his agent. Any of the parties to the transaction may pay the tax.

### The Base of the Tax

A tax on the conveyance of real property may be levied in several ways.<sup>3</sup> First, the tax may be imposed on the total value of the property transferred.

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3. For a full discussion of the strengths and weakness of the various real estate transfer tax alternatives see Wilma Mayers, "The Real Estate Transfer Tax," Sources of Revenue Not Now Used by California, Assembly Interim Committee on Revenue and Taxation, (Sacramento, December, 1964).

This method provides the most inclusive base and closely parallels an extension of the sales tax to real property but at a lower rate. Second, the value of the equity transferred may be taxed. This approach tends to narrow the base somewhat since the amount of the mortgage must be deducted from the sales price. The Federal documentary stamp tax is imposed only on net consideration and may be characterized as an "equity" impost. Third, a tax may be imposed on the mortgage itself. Mortgage recording taxes are sometimes imposed along with the broader "sales" transfer taxes.

### Locally Imposed Transfer Taxes

In addition to the Federal government and twenty-three states, several local governments use real property conveyance taxes. (See Table 28.) In New York City both a tax on the conveyance of real property and a mortgage tax have imposed for some years.<sup>4</sup> The real property transfer tax is levied at a rate of one-half percent of the net consideration on each deed that exceeds \$25,000. Another state, Pennsylvania, levies a realty transfer tax of 1 percent of the value of the property transferred. This was supplemented in Philadelphia by a 1 percent transfer tax which nets that city over \$3.5 million dollars annually, or approximately the same amount that is produced in New York City with a lower tax rate (with exemptions). Other local property transfer taxes have been enacted in Baltimore, Pittsburgh, the District of Columbia, and in various other counties in the States of Maryland, Pennsylvania, Virginia and Washington. In general they provide small amounts that supplement the communities' other sources of revenue, but do not carry a "base load" for the local tax system. As has been demonstrated in these cities, the property transfer tax is quite capable of providing modest yields at rates substantially higher than the Federal rate of 0.11 percent without imposing particular hardships either on buyers or sellers of real estate.

### Potential Yield of the Transfer Tax

The rate structure and the base of a real property transfer tax may be so designed that the small homeowner escapes payment of the tax. Table 29

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4. The mortgage recording tax dates back to 1906; there have been no changes in rates during the period since the tax was first levied at 50 cents for each \$100 of mortgage. Technically, the tax is levied by the State. However, the City retains all collections and is responsible itself for collecting the tax.

TABLE 28 -- STATE DOCUMENTARY TAXES, JANUARY 1, 1967

State and type of tax	Rate Jan. 1, 1967	Use of stamps	Distribution of receipts		State collections 1965 (thousands) <sup>1/</sup>
			State	Local	
Alabama:					
Transfer of property	50¢/\$500 <sup>2/</sup>	No	2/3	1/3	\$1,573
Mortgages	15¢/\$100	No	2/3	1/3	
Issuance of stocks and bonds	25¢/\$100	No	All	.....	
Transfer of mineral leaseholds	5-15¢/acre <sup>3/</sup>	No	.....	All	
Delaware:					
Transfer of real estate	1%	Yes	All	.....	.....
District of Columbia:					
Transfer of real estate	0.5%	No	.....	All	\$1,886
Florida:					
Issuance and transfer of stocks and bonds	15¢/\$100	Yes	All	.....	\$27,465
Transfer of real estate	30¢/\$100	Yes	All	.....	
Hawaii:					
Transfer of real estate	0.5%	Yes	All	.....	.....
Indiana:					
Transfer of real estate	2% <sup>2/</sup>	Yes	All	.....	n.a.
Iowa: <sup>4/</sup>					
Transfer of real estate	55¢/\$500	Yes	All	.....	.....
Kansas:					
Mortgages	25¢/\$100	No	.....	All	.....
Maryland: <sup>5/</sup>					
Transfer of property	55¢/\$500	Yes	.....	All <sup>6/</sup>	\$34
Mortgages	55¢/\$500	Yes	.....	All <sup>6/</sup>	
Massachusetts:					
Transfer of real estate	55¢/\$500 <sup>2/ &amp; 7/</sup>	Yes	All	.....	\$1,729
Michigan: <sup>4/</sup>					
Transfer of real estate	\$1.10/\$500	Yes	.....	All	.....
Minnesota:					
Transfer of real estate	55¢/\$500 <sup>2/ &amp; 8/</sup>	Yes	All	.....	\$1,434
Mortgages	15¢/\$100	No	1/6	5/6 <sup>9/</sup>	
Mississippi:					
Transfer of mineral leaseholds	3-8¢/acre <sup>3/</sup>	Yes	.....	All	.....
Nebraska: <sup>4/</sup>					
Transfer of real estate	55¢/\$500	Yes	All	.....	.....
New York: <sup>10/</sup>					
Transfer of stock	1 1/4-5¢/share <sup>11/</sup>	Yes	All	.....	\$80,826
Mortgages	50¢/\$100	No	.....	All	.....
Oklahoma:					
Mortgages	2-10¢/\$100	No	.....	All	.....
Pennsylvania: <sup>12/</sup>					
Transfer of real estate	1% <sup>2/</sup>	Yes	All	.....	\$22,398
Rhode Island: <sup>4/</sup>					
Transfer of real estate	55¢/\$500	<sup>13/</sup>	All	.....	.....
South Carolina:					
Issuance of stocks and bonds	10¢/\$100	Yes	All	.....	\$2,008
Transfer of stocks	4¢/\$100	Yes	All	.....	
Transfer of real estate	\$1/\$500 <sup>2/</sup>	Yes	All	.....	
Tennessee:					
Transfer of real estate	\$1.50/\$1000	No	All	.....	\$2,500
Mortgages	10¢/\$100	No	All	.....	
Texas:					
Transfer of stock	3.3¢/\$100	Yes	All	.....	\$160
Virginia: <sup>14/</sup>					
Transfer of real estate	15¢/\$100	No	All	.....	\$5,770
Mortgages	15¢/\$100	No	All	.....	
Washington: <sup>15/</sup>					
Transfer of real estate	50¢/\$500	Yes	All	.....	\$1,048
West Virginia:					
Transfer of real estate	\$1.10/\$500	Yes	All	.....	\$595
TOTAL	.....	.....	.....	.....	\$149,426

n.a.-Data not available.

<sup>1/</sup> Excludes amounts collected and retained by local governments. Data are preliminary.<sup>2/</sup> Exclusive of assumed mortgages. The Indiana tax is applicable only to corporations subject to gross income tax.<sup>3/</sup> Depending on length of lease.

(Footnotes continued)

TABLE 28 (CONTINUED)

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- 4/ Effective January 1, 1968, when the Federal real estate transfer tax is repealed.
  - 5/ The city of Baltimore and specified counties are authorized to supplement the State tax.
  - 6/ Except that tax on recordation of instruments granting encumbrances on property situated in two or more counties as security for corporate bonds of public utilities, are paid to the State.
  - 7/ Rate is \$1 on first \$500.
  - 8/ Rate is \$1.10 on first \$1,000.
  - 9/ Except that the tax on mortgages that are secured by property exempt from property taxation is paid to the State.
  - 10/ New York City imposes a tax of 0.5% on transfers of real property where the consideration exceeds \$25,000. Assumed mortgages are excluded in computing the tax.
  - 11/ Depending upon value per share.
  - 12/ Local governments are authorized to impose a real estate transfer tax up to 1% and about 1500 including more than 800 school districts, have done so.
  - 13/ Not specified.
  - 14/ Counties and cities levy a tax of 1/3 the State tax (5¢/\$100).
  - 15/ Counties are authorized to levy a 1% real estate sales tax; all 39 counties have done so.
- 

Source: Reproduced from Advisory Commission on Intergovernmental Relations, Tax Overlapping in the United States: Selected Tables Updated (January 1, 1967), Table 93 (pp. 62-63).

shows the actual size distribution of measurable sales of real property during a recent year. While almost 80 percent of any potential tax base built up by measurable sales of real property during a recent year. While almost 80 percent of any potential tax base built up by measurable sales lies below the \$20,000 assessed value level, a sufficiently large volume of transfers occurs beyond the \$20,000 mark to make this impost worthy of further investigation. Based upon Census data for sales in San Francisco, it appears that almost \$53 million dollars worth of sales occur in the open-ended interval, "\$20,000 and over." (See Table 30.) One could estimate, therefore, that the Federal government is presently collecting less than \$58,000 in this bracket, and something less than \$290,000 from all real property sales since the Federal base is narrower than sales value. If a tax were imposed on the sales value of transfers at the old Federal rate, and if it were to apply only to the "20,000 and over assessed value" bracket, it would scarcely be worthwhile imposing a tax at all since the yield would barely exceed \$50,000. However, if the tax rate were increased to two-thirds of 1 percent (a rather mild tax compared to the Philadelphia levy) for the value of over \$20,000 (assessed value over \$5,000) a nominal 0.11 percent tax were retained on smaller sales, almost \$835,000 could be produced by this tax.



TABLE 29

## PERCENT DISTRIBUTION OF MEASURABLE SALES OF PROPERTY

Assessed Value Price Class	Total	Houses	Apartments	Vacant Lots	Commercial	Industrial	Other
Under \$5,000	52.9%	32.8%	14.8%	1.7%	1.8%	1.1%	0.7%
\$5,000 - 20,000	27.0	3.9	14.4	0.7	5.9	2.0	-
\$20,000 and over	20.0	0.3	6.2	-	8.4	5.1	-
Total, all classes	100.0%	37.0%	35.5%	2.4%	16.2%	8.1%	0.7%

Note: Detail will not add to totals due to rounding.

Source: Computed from US Bureau of the Census, Census of Governments, 1961 data (unpublished)

TABLE 30

MEASURABLE SALES OF PROPERTY IN SAN FRANCISCO

<u>Assessed Value Price Class</u>	<u>Total</u>	<u>Percent Distribution</u>
	(thousands)	
Under \$5,000	\$139,290	52.9%
\$5,000-20,000	71,238	27.0
\$20,000-and over	52,836	26.6
Total, all classes	\$263,364	100.0%

Source: Computed from U. S. Bureau of the Census, Census of Governments  
data (unpublished) on measurable property sales in 1961.

(See Table 31.) If the tax on sales in this highest bracket was increased to 1 percent, the City could realize an additional \$176,000 in revenue.

### An Aid to Better Property Tax Assessment

There is another strong reason why the City should move into this area of taxation. A real property transfer tax is an adjunct to sound property tax administration. With this impost a deed may not be recorded without a receipt. The parties to a taxable transaction must quote a sales price to obtain the receipt. In so doing, additional information is provided to the assessor. He will thus be able to check continuously the quality of his own assessment, thereby insuring that the assessment roll does not lag too far behind market changes. Employment of a graduated rate structure that will tax larger sales more heavily is desirable not only on equity grounds but also because it will serve as a deterrent to the overstatement of the sales price on properties bought for speculative reasons. Occasionally a buyer will want to conceal the true purchase price and mislead another prospective buyer by purchasing more stamps than he needs, thereby creating the illusion that he paid a much higher price for his property. If the documentary stamps are priced high enough, the speculator will be discouraged from engaging in this type of deception. The present low federal rate, 0.11 percent, is not sufficiently high to accomplish this. By combining a differential rate with a sales value base, not only will speculators be discouraged from falsifying sales prices but also the small home owner will be paying little more than he is at present.

### Low Administrative Cost

There is ample reason to believe that the costs of administering this levy would be quite low. In the State of Washington the administrative costs have been reported to be 1 percent of gross collections. In San Francisco costs should be no higher. Discussions with Virgil Elliot, Director of Finance and Records, supported this contention. Present staff could easily cope with the responsibility of issuing stamps and receipts. The only out-of-pocket costs for the City would be those for the stamps themselves.

## CIGARETTE TAXES

### Background

Cigarettes and tobacco products have been traditionally singled out for excising. The case for taxing these items rests on two grounds. First, the demand for cigarettes is relatively inelastic--as prices rise, smokers continue to

TABLE 31

ESTIMATED YIELD OF A CITY REAL ESTATE TRANSFER TAX

<u>Assessed Value Price Class</u>	<u>Rate</u>	<u>Yield</u>
I. With exemptions		
Under \$5,000	-	-
\$5,000-20,000	-	-
\$20,000 and over	0.11%	\$58,119
Total, all classes	-	\$58,119
II. Without exemptions:		
Under \$5,000	0.11%	\$153,219
\$5,000-20,000	0.11	78,362
\$20,000 and over	0.667	352,416
Total, all classes		\$583,997

Source: computed from Table 30.

purchase cigarettes in quantities nearly as large as they did during pre-tax periods. Second, cigarettes have been a prime target of various religious, physical culture and health groups who have been interested in curtailing their consumption. As a result legislative bodies at all levels of government have been rather permissive toward attempts to impose or increase cigarette and tobacco taxes. Today, not only does the State of California levy a cigarette tax, but so do 35 municipalities within the state. The outlook for the future points to an even greater proliferation of these locally imposed taxes unless the state steps in with a uniform local cigarette sales tax law patterned along lines similar to the Bradley-Burns statute.

Several problems have arisen in connection with these justifications for the cigarette tax. First, while cigarette consumption may be relatively insensitive to price, buying patterns are not. If state and/or local cigarette taxes are sufficiently high, consumers will begin to buy their cigarettes in convenient establishments located outside the jurisdiction that imposes the tax. At first, commuters may begin to buy their cigarettes at home rather than within a city imposing such a tax. Occasionally, residents may also purchase a carton or two outside their city. Next, residents may break established buying patterns by "stocking up on cigarettes" at every available opportunity outside the city. Finally, when the price differential between areas becomes sufficiently high, there exists considerable incentive for consumers to make special trips to buy cigarettes and while doing so to purchase other, unrelated items. Or, worse, "bootlegging" may commence, and untaxed cigarettes will be shipped across state and county lines where they will find their way to undercover outlets.

It is hardly likely that a 1 or 2 cent per pack tax imposed by a California community would lead to any condition but realization of the first alternative discussed -- that is a change in the buying patterns of some commuters and an occasional resident.

The State of California currently has a low cigarette tax. Only Kentucky, which has a 2.5¢ per pack tax, and North Carolina, which has no tax at all, have lower cigarette taxes than does California. Further, it is hardly probable that any price differential existing between California and North Carolina would engender the type of unlawful situation now existing between that southern state and the other Middle Atlantic states and New York wherein bootlegging is fairly common. On the contrary, the states surrounding California have higher, not lower, cigarette taxes.

At present California's locally imposed cigarette taxes are low enough that major dislocation is not evident. Table 32 suggests that these locally imposed taxes may have some impact on sales and this impact may be generally negative, although in some communities per capita consumption actually increases with the tax rate. Los Angeles, for instance, consumes about 14 percent fewer cigarettes

TABLE 32

PER CAPITA CIGARETTE SALES IN SELECTED CALIFORNIA  
MUNICIPALITIES IMPOSING CIGARETTE TAXES, 1966

Municipality	Rate of Tax per Pack Applicable During			Tax-Paid Sales in Packs		Local per Capita Compared with State per Capita (% difference)
	12-Month	Collection Period		per Capita for:		
	State	Local	Combined	Entire State	Local	
Berkeley	3¢	2¢	5¢	136.8	83.2	-39.2%
Burbank	3	2	5	136.8	187.2	+36.8
Compton	3	2	5	136.8	108.1	-21.0
Culver City	3	2	5	136.8	284.4	+107.9
Downey	3	2	5	136.8	134.4	-1.8
Glendale	3	2	5	136.8	115.8	-15.4
Inglewood	3	2	5	136.8	140.2	+2.5
Long Beach	3	2	5	136.8	90.1	-34.1
Los Angeles	3	2	5	136.8	117.3	-14.3
Mountain View	3	2	5	136.8	121.5	-11.2
Pasadena	3	2	5	136.8	104.5	-23.6
Pomona	3	2	5	136.8	126.5	-7.5
San Bernardino	3	2	5	136.8	112.0	-18.1
San Diego	3	2	5	136.8	94.6	-30.8
San Jose	3	2	5	136.8	109.8	-19.7
Santa Clara	3	2	5	136.8	115.5	-15.6
Torrence	3	2	5	136.8	125.3	-8.4

Source: Tobacco Tax Council, Inc.

than does the state as a whole. Although there are other factors such as sex, age, ethics, income, etc., related to cigarette consumption, it is reasonable to suppose that the Los Angeles differential is of some significance in that the populations under comparison, Los Angeles' and the state's, are probably most nearly comparable in respect to these important factors. It is probably fairly accurate to maintain, therefore, that a 2-cent increase in the price of cigarettes would have at least as great an effect on another heterogeneous population such as San Francisco's.

The second justification for the cigarette tax is also weak, i.e., that cigarettes are harmful, unnecessary goods and should be taxed, and its corollary, that anyone who wants to avoid the tax may easily do so by not buying cigarettes, is equally weak and unconvincing.

Actually, tobacco is singled out for taxation because of the intensity of demand for cigarettes no matter what the price (within reason). No one really expects cigarette consumption to drop; this fact exposes the hypocrisy of this apology. Honestly stated, cigarettes are singled out for taxation because they are relatively easy items to tax and the demand is reasonably constant.<sup>5</sup>

#### Yield

If San Francisco were to enact a 2-cent per pack cigarette sales tax, approximately \$1.7 million in new revenue could be realized. This estimate is based on per capita consumption of cigarettes in Los Angeles (117.3 packs) which already has the 2-cent levy. No one could predict exactly how much of an impact a 2-cent tax would have on consumption, but it is eminently reasonable to suppose that the effect on cigarette sales would be to reduce them somewhere between 12 and 15 percent.<sup>6</sup>

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5. Harold Groves has made an interesting observation on this phenomenon:

"Tobacco consumption falls in the area of compensatory psychology. One "needs" a smoke largely to favor himself in moments of boredom and fatigue. The more the favor costs the individual the greater favor it constitutes. The British, partly to conserve foreign exchange, have put this theory to its severest test and it has held up remarkably well. The British tobacco tax alone yields almost as much relative to total revenue as the entire excise tax system of the United States."

cf: Financing Government, 6th edition (Holt Rinehart and Winston, New York, 1964), p. 279.

6. Berkeley, a Bay Area community with a cigarette tax, has per capita sales of cigarettes about 39 percent lower than the State's figure. It is probable that other factors than price, such as age, education, and the structure of the retailing industry in the area, are responsible for this phenomenon. No data on sales in Oakland was available.

Based upon experience in other California communities, costs of collection and administration of this tax should run around 3 percent, or about \$50,000. It should be pointed out that the very attribute of cigarettes which legislators find appealing as an object of taxation, that is, the insensitivity of their demand schedules to income or price, makes cigarette taxation a poor bet as a growth tax. As income rises, cigarette consumption increases, but only very slightly. Two other factors would also play a part in the growth potential of this impost. First, increasing tourism is bound to bring in additional sales. Second, and this will certainly offset the first to some degree, per capita cigarette sales have declined mainly as a result of the Surgeon General's report and subsequent medical pronouncements. While no one can say exactly how fast cigarette revenue would grow, there is ample cause to believe that its growth will be far from rapid.

### Incidence

Cigarettes are an ideal consumer's good. That is, they are valued for the direct utility that they provide to a smoker. Seldom are cigarettes demanded jointly, or in combination with any other significant good, nor are they used in any intermediate stage of production. (Occasionally, cigarette buying habits may be linked to the purchasing of other items, however.) If the tax is levied on tobacco products at the distributor's level, as is normal, the legal impact will be on business, and the tax will be treated as a recoverable cost down through the distribution network. This process, coupled with intense demand, produces a forward-shifted tax whereby the actual burden falls upon the consumer.

Nevertheless, it is entirely possible to conceive of a dislocational factor that would be connected with a locally imposed cigarette tax. As mentioned previously, some smokers will find themselves living and working within a trading or market area that includes both a jurisdiction that taxes cigarettes and one that does not. To the extent that the consumer will be motivated to break his established buying habits and buy from new sources, the tax may be said to be backward shifted to the vendors operating within the taxed jurisdiction. In the long-run, however, the marketing of cigarettes will become stabilized and local vendors will readjust and shift the tax forward to consumers.

Table 33 and Figure 5 reveal the cigarette tax to be essentially regressive. This is because tobacco expenditures increase as income rises, but not nearly as rapidly. The apparent progression below the \$2,000 bracket occurs because these families are generally poor and have money barely for subsistence.<sup>7</sup> Except for an unaccountable break in the \$4,000 to \$5,000 class, the cigarette tax is regressive and rather steeply so.

7. Even in the lowest income brackets a group of people will be found who are there through accident; they have negative or low incomes because they realized some sort of capital loss, were sick, in school, or otherwise temporarily out of the high-income class. They will tend to consume in a manner more closely resembling their normal bracket than that of the one they occupy temporarily.



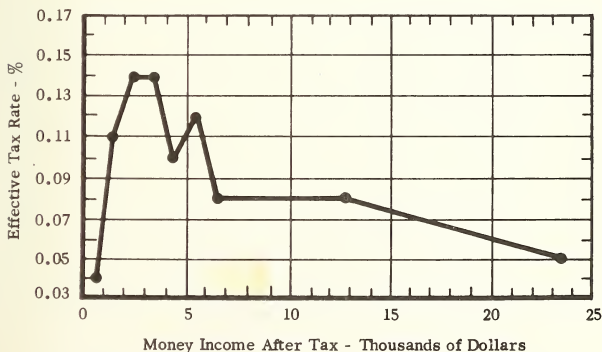
TABLE 33

HYPOTHETICAL TWO CENTS PER PACK CIGARETTE TAX BURDEN  
BY INCOME CLASS

<u>Money Income<sup>a</sup></u>	<u>Tax Burden per Family<sup>a</sup></u>	
	<u>Amount</u>	<u>As Percent of Income</u>
Under \$1,000	\$ .28	.04%
\$1,000 - 2,000	1.79	.11
2,000 - 3,000	3.52	.14
3,000 - 4,000	4.82	.14
4,000 - 5,000	4.28	.10
5,000 - 6,000	6.62	.12
6,000 - 7,500	5.52	.08
7,500 - 10,000	7.10	.08
10,000 - 15,000	8.97	.08
15,000 and over	10.76	.05

a. After-taxes

Source: Computed from data from BLS Survey of Consumer Expenditures, San Francisco, California, 1960-61; see text.



Source: Table 33

FIGURE 5      BURDEN OF HYPOTHETICAL TWO-CENT-  
PER-PACK CIGARETTE TAX

## SALES TAX

### Policy Constraints

The City of San Francisco imposes a 1-cent retail sales and use tax. This tax is levied in conformity with the state's Bradley-Burns Uniform Local Sales and Use Tax Law which was enacted in 1955 to insure consistency in rate and coverage among local sales taxes. Collections are made by the State Board of Equalization which remits proceeds to the City on a quarterly basis. By entering into partnership with the state, and thereby taking advantage of the state's expertise and efficiency in the administration of the impost, the City surrenders the right either to increase the rate by more than 1 percent or to change the base (e.g., extend the base to include services exempt under state law). There seems to be little basis for jettisoning the agreement with the State in order to raise the sales tax 1 or 2 percent, since San Francisco would run headlong into both high administrative costs and a potentially harmful situation wherein other Bay Area communities would simply stand fast on their Bradley-Burns agreements and reap the benefits of a commercial windfall.<sup>8</sup>

The City thus appears effectively constrained at the moment in this field of taxation. No attempt was made therefore to discuss the potential yield of an additional 1 percent levy. However, it is reasonable to believe that a 1 percent tax differential between San Francisco and the rest of the Bay Area should cause the City to lose from 5 to 8 percent on its taxable sales, a high price to pay for another \$15 to \$18 million in taxes.

On balance, the performance of the sales tax has not been a bad one in San Francisco. The tax has been painless for the City to administer, reasonably responsive to changes in income (it increased at a 4.7 percent rate between 1964 and 1965) and has doubtlessly created less distortion in both business and individual locational choices than has the property tax. Perhaps the worst thing that could be said about San Francisco's small sales tax is that under the present state law the sales tax yield (representing about 10 percent of total City tax collections) is extremely modest. Moreover, there is ample indication that the next change in state law will benefit the state rather than the City, thereby effectively eliminating the hope of some that the state would

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8. The effects of 1 or 2 percent sales tax differentials between adjacent urban areas have been documented for New York City by William Hamovitch in "Effects of Increases in Sales Tax Rates on Taxable Sales in New York City," *In Financing Government in New York City* (New York University, 1966); Hamovitch concludes that there is a drop of about 6 percent in taxable sales for each one-point tax differential between New York City and the surrounding counties.

permit the cities to further exploit the sales tax by granting them permission to increase the rate by 1 percent.<sup>9</sup>

### Incidence

For a long time the attention of organized labor and other interest groups was focused on the "regressivity" or inequity of the sales tax. The belief that the tax was regressive was partly a result of the mistaken idea that retail sales taxes, as actually imposed, bore a close relationship to the general sales or consumption taxes described in economics text books. It was also partly a result of political maneuvering in areas lacking any broad-based tax but the property tax. Certain groups frequently undermined arguments in favor of sales taxation in order to further the chances of an income tax, the impost that possesses the largest capacity to take ability-to-pay into account.

In recent years, numerous tax studies, including some of the California system itself, have concluded that the retail sales tax is essentially not a regressive impost.<sup>10</sup> These studies have combined orthodox tax incidence theory, e.g. the sales tax is primarily paid by consumers, with survey data on consumer expenditures. These studies have shown repeatedly that because low-income families spend most of their money on goods and services which are not taxable, e.g., rent, food consumed at home, gas and electricity, etc., the direct burden of the retail sales tax falls lightly on them. For higher-income families the tax burden is much greater since they eat a higher proportion of their meals in restaurants, purchase a long list of consumer durables (almost all of which are taxable), buy new cars more often, and otherwise find ways to spend their money on taxable goods.

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9. Governor Ronald Reagan has proposed that the State rate be raised to 4 percent; cf. "Tax Message Transmitted to the California Legislature," March 8, 1967, p. 9.
10. A partial list of "official" studies showing the sales tax not regressive includes: Harold Sommers, Assembly Interim Committee on Revenue and Taxation, The Sales Tax (Sacramento, December 1964); Senate Fact Finding Committee on Revenue and Taxation, General Fund Consumption Taxes (Sacramento, January 1965); and William H. Hickman, Distribution of the Burden of California Sales and Other Excise Taxes (State Board of Equalization, Sacramento, October 1958). Other investigations of sales tax incidence include David Davies, "The Relative Burden of Sales Taxation: A Statistical Analysis of California Data," American Journal of Economics and Sociology, Vol. 19 (April 1960), pp. 292-293; and "Progressiveness of a Sales Tax," The American Economic Review, Vol. L (December 1960); and Reed Hansen, "An Empirical Analysis of the Retail Sales Tax with Policy Recommendations," National Tax Journal, Vol. 15 (March 1962), pp. 1-13. See also Appendix D of this report.

The distribution of the present burden of the City's 1 percent sales tax is approximated in Table 34 and Figure 6, which clearly show the essentially equitable distribution of the sales tax burden. Only for the \$2,000 to \$3,000 bracket can the tax be said to be mildly regressive.<sup>11</sup> This finding is fully consistent with other empirical studies. The tax burden distribution shown in Table 34 and Figure 6 reflects the fact that the City's poor have proportionally less money available to purchase taxable goods than do higher income groups. For instance, a family earning \$3,000 to \$4,000 per year is paying about \$11 a year in taxes, or less than 0.3 percent of its total income. But a family earning about \$8,500 will pay about \$43 in taxes, or 0.5 percent of its income.

In summary, it is difficult to conclude that the California sales tax is anything but a proportional tax. Even if one's notion of equity calls for something more than proportionality in the distribution of the tax burden, there is no question that the sales tax is more equitable than San Francisco's main revenue source--the property tax.<sup>12</sup>

### Extending the Sales Tax to Services

San Francisco may not extend its Bradley-Burns sales tax agreement to cover services. Nevertheless, the City may enact a special sales tax ordinance which could cover a wide range of personal and business services. If San Francisco chooses this course of action, it will be necessary for the City to collect the proceeds without the assistance of the State. However, there is little question that the City has the right to impose such a tax if it so desires since it is a Charter Law City and thus receives its taxation powers directly from the State Constitution. Considerable latitude is open to San Francisco concerning what services to tax, and the City could make the law as inclusive as it desires. If the City does choose to tax services, however, it must recognize basic problems connected with this form of taxation.

### Incidence

The consumer would bear the major impact of a tax on services. To the degree that the service tax would fall on intermediate services destined for use by other businesses, the incidence of the tax would be quite uncertain. On the one hand, a tax on personal services (e.g., haircutting, shoe repairing, dry cleaning, etc.) would most likely work itself forward to consumers. On the other

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11. For a definition of regressive taxation, see Chapter III, footnote 8.

12. For a discussion of the incidence of the property tax, see Chapter III.

TABLE 34

ESTIMATED BURDEN OF ONE PERCENT SALES TAX ON CITY FAMILIES  
BY INCOME CLASS

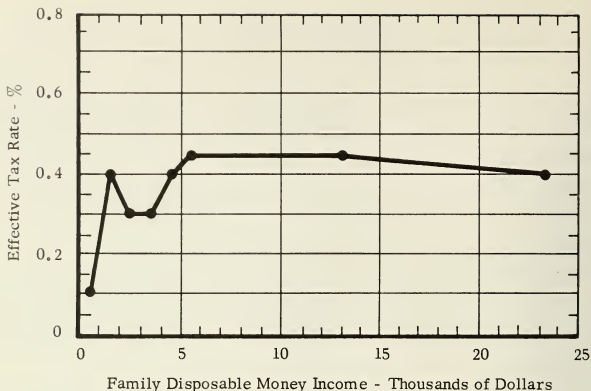
<u>Income Class</u>	<u>Estimated Money Burden<sup>a</sup></u>	<u>Money Burden as Percent of Income (Effective Tax Rate)</u>
Under \$1,000	\$ .60	.1%
\$1,000 - 1,999	6.46	.4
2,000 - 2,999	8.41	.3
3,000 - 3,999	11.00	.3
4,000 - 4,999	18.50	.4
5,000 - 5,999	29.54	.5
6,000 - 7,499	35.33	.5
7,500 - 9,999	42.57	.5
10,000 - 14,999	56.30	.5
15,000 or over	90.61	.4

a. Based on analysis of taxable consumption expenditures by income class.

Computed from Bureau of Labor Statistics, Survey of Consumer Expenditures 1960-61, San Francisco, California, 1960-61 data.

hand, a tax on advertising, equipment rentals, sign painting, etc., would result not only in higher business tax burdens but also in undesirable tax pyramiding<sup>13</sup> effects as well. Moreover, firms using large quantities of taxed services, those oriented more toward the external benefits of the City, would be taxed unusually hard and, in effect, penalized both for being located in San Francisco and being highly specialized. A tax so imposed would amount to a crude gross receipts tax levied only on the service sector without any regard to the economic or social desirability of the retention or encouragement of such firms. The effects of a service tax on business services is bound to have capricious, uncertain, and undesirable results.

13. For a discussion of "pyramiding," see Chapter IV.



Source: Table 34

FIGURE 6 BURDEN OF ONE PERCENT SALES TAX ON  
SAN FRANCISCO FAMILIES

The effects on consumers of a tax on personal services would also be objectionable on another ground, equity. Personal services consist largely of such items as beauty parlors, shoe repair, diaper services, funeral services, laundries, etc. These services are consumed in quantity by low- and middle-income families, unlike many types of taxable goods, which the consumer can forego. Families at this income level need these services and their consumption undoubtedly represents some collective good from the viewpoint of health and welfare. One may view a 1 percent increase in the existing sales tax as a much more equitable step than extending the coverage of the sales tax to personal services; the latter would produce an even more regressive tax system than exists at present.

#### Yield

The main classifications of service-oriented industries are personal services, miscellaneous business services, auto repair, and professional services. Table 35 indicates what the base of a service tax might be and what that base might yield. Not all the receipts of these establishments would be taxable by the City as many sell goods as well as services, and a large portion of certain types of sales are made outside the City.

TABLE 35

ESTIMATED YIELD OF SALES TAX ON  
SELECTED SERVICES

<u>Industry</u>	<u>Estimated Taxable Receipts</u> <u>(thousands)</u>	<u>Yield @ 4%</u>
Personal services	\$ 69,000	\$ 2,760,000
Business services	224,800	8,992,000
Auto repair	49,500	1,980,000
Miscellaneous	21,300	852,000
Professional	n.a. <sup>a</sup>	n.a. <sup>a</sup>
Utilities	304,832 <sup>b</sup>	12,192,000

a. It is obviously unwise to consider taxing medical, health and legal services because the burden will undoubtedly be shifted forward to consumers and because these services are traditionally untaxed or taxed at extremely low rates in this country.

b. Assumes sale of utilities to commercial users would be taxable.

Note: These estimates are crude; however, the undesirability of extending a large service tax that would, or could, in effect, become an onerous gross receipts tax on the service sector, is so clear-cut that further refinement of the data appears unnecessary. Thus, the figures cited are more in the way of a first approximation or illustration of the amounts involved.

Over \$26 million could be raised by adopting a comprehensive series of selective excises (or occupational licenses measured by gross receipts) provided one were completely indifferent to harmful inter-industry effects and to increasing the regressive qualities of the tax system. To accomplish this, a small army of auditors, perhaps as many as three hundred or so, would have to be hired. The small size of many service-oriented firms, coupled with the transient nature of others and the large number of self-employed individuals involved, would undoubtedly mean high administrative costs for the City.

## THE AMUSEMENT TAX

### Background

An amusement tax may vary in scope from a theater or movie admission surcharge to a tax on a variety of leisure-time activities, including golf, tennis and boating. Normally, however, a locally imposed amusement tax is directed toward the consumers of the commercially provided services of motion picture theaters, dance halls, sports arenas and amusement parks. The complexity of seriously attempting to tax leisure-time activities per se is so formidable that a jurisdiction will limit the base of the tax to those services which are provided by commercial operations located at a fixed place of business and which can be relied upon to comply with the taxing regulations.

The justification for the taxation of amusement services really rests upon the same foundation as do most selective sales and use taxes--administrative and/or political expediency. Sometimes other apologies are offered. For instance, it has been argued that unlike most selective sales taxes, an amusement tax would presumably not tax the "necessities" of life. A poor person can fully avoid paying any amusement tax by simply trading leisure time for work time if only he chooses to. This argument is not believable since the very rate of amusement taxation is ordinarily not high enough to cause a shift in demand. Perhaps the only thing that does happen is to motivate the consumer to allocate more of his leisure time to pastimes that are not taxed. It may also be argued that the amusement tax would achieve the same result as does the hotel tax in respect to exacting taxes from tourists in return for the benefits of government they receive. This argument may be true for tourists, but amusement services are purchased by both tourists and residents. Hotel services are rarely purchased by both.



## Incidence

It is reasonable to assume that a small amusement levy would be shifted forward. If so, Table 36 and Figure 7 given an approximation of the allocation of a hypothetical 4 percent tax burden. After allocating the tax burden by means of Bureau of Labor Statistics survey data on recreation expenditures, no clear regressive or progressive pattern emerges. The tax burden appears regressive through part of the income scale, suddenly breaks upward for one or two brackets, falters, then rises only to sink once again through the highest income bracket, \$15,000 and over. The dominant feature of the burden of the amusement tax is really a haphazard incidence. It is not consistently regressive, proportional, or progressive. Perhaps the one thing which could be said in favor of the tax is that it extracts very small amounts of funds from taxpayers. This is small praise, however.

## Yield

A hypothetical tax base consisting of motion picture theaters, theatrical presentations, commercial sports, amusement and kiddie parks, carnivals, circuses, etc., should approach \$35 million.<sup>14</sup> If a tax were levied, the following yields could be realized:

1 percent	\$350,000
2 percent	700,000
3 percent	1,050,000
4 percent	1,400,000
5 percent	1,750,000

The costs of administering this tax would vary according to the City's ability to blend in added responsibilities and work loads to on-going city agencies. These costs would probably run between \$30,000 and \$50,000 if an entirely new staff were utilized.

## Policy

In summary, if selective sales or "sumptuary" taxes are to be employed in San Francisco, the City would be better off relying on an increased hotel-motel tax or a cigarette tax. The amusement tax is the poorest choice of the three alternatives.

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14. Estimate derived from detail in U. S. Bureau of the Census, Census of Business, 1963, Selected Services, California.

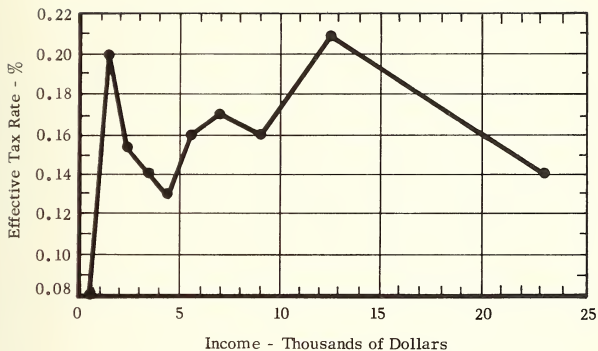
TABLE 36

DISTRIBUTION OF THE BURDEN OF A HYPOTHETICAL FOUR PERCENT  
AMUSEMENT TAX BY INCOME CLASS

	<u>Estimated Tax</u> <sup>a</sup>	<u>Effective Tax Rate</u> (Tax as percent of income)
Under \$1,000	\$ .56	.08%
1,000 - 1,999	4.40	.20
2,000 - 2,999	3.76	.15
3,000 - 3,999	4.80	.14
4,000 - 4,999	5.76	.13
5,000 - 5,999	8.52	.16
6,000 - 7,499	11.76	.17
7,500 - 9,999	13.60	.16
10,000 - 14,999	24.84	.21
15,000 and over	30.68	.14

a. Estimated by assuming that three quarters of BLS recreation expenditures are taxable.

Source: Computed from BLS, Survey of Consumer Expenditures, 1960-61, San Francisco, California data.



Source: Computed from Table 36

FIGURE 7 BURDEN OF HYPOTHETICAL FOUR PERCENT  
AMUSEMENT TAX BY INCOME CLASS



## CHAPTER VII

### USER CHARGES

#### THE ROLE OF USER CHARGES IN A CITY'S REVENUE STRUCTURE

Virtually the entire multitude of activities performed by local governments can be placed into one of three categories. First, there are those sources which offer *diffused benefits* to the whole community. In some cases, the direct recipients can be identified, but there is considerable "spill-over" to the rest of the community, justifying financing through a broad-based tax. Education is perhaps the best example of this kind of service. In other cases, beneficiaries cannot be clearly identified, and it is presumed that individuals benefit in proportion to tax liabilities. Police service financed through a general property tax is an example of this type of municipal service.

The second category includes *redistributive* services whereby income is transferred from higher to lower income groups. Obviously, it would be self-defeating to charge beneficiaries any part of the cost of these services. Hence, we logically finance such services as welfare grants and public housing through the general tax system.

The third group consists of those services which *directly benefit their users* with little or no diffusion throughout the community. Many of these services, such as the provision of water, power and transportation, are now performed by local government only through tradition or accident, and could presumably be equally well provided through the private sector of the economy. For example, transportation services are provided by the cities in San Francisco, New York, and Boston; but in Philadelphia, Washington, and Los Angeles private companies operate the transit lines. Similar examples of mixed private and government operations can be provided for all other types of public utilities.

Even outside the area of the public utilities, one can find examples of municipal services which provide benefits exclusively to users. While parks can be said to be community amenities providing visual or esthetic benefits not closely correlated with direct use, some of their facilities, such as tennis courts, golf courses and zoos, are of sole benefit to users, who can justifiably be asked to pay the costs of providing and operating them. Sometimes a fine line must be drawn--is a museum an educational institution with diffuse cultural benefits, or is it a facility which provides utility to its users and to no one else?



Some activities which involve supervision or licensing to insure that participants adhere to standards which will protect public health or safety are properly chargeable to those who undergo the regulation. They are participants, as it were, in potentially hazardous activities and should logically pay the cost of their own control. Thus, industrial air-polluters, who create social costs, should either be obliged to install pollution-inhibiting devices or to pay the cost of air-pollution inspectors who watch for violations.

### UTILITY-TYPE ACTIVITIES

In San Francisco, a minimum of five services can be classified as public utility-type activities where at least an *a priori* case can be made for charging users for full cost of the service, including, where possible, a property tax equivalent and an appropriate interest charge on public investment. The latter point cannot be too strongly emphasized. More often than not, as in San Francisco, municipalities charge off only current expenditures to users, allocating capital charges (except interest on debts) to the property tax, thereby showing a fictitious profit. Needless to say, a privately owned utility could not show a profit under that same rate schedule since it has no taxing power upon which it can rely to pay capital costs.

To calculate the true economic cost of providing a particular service, it is necessary to substitute for current capital outlays and debt amortization an appropriate rental charge representing interest on the value of the facilities used. In San Francisco, for example, during fiscal year 1966, the Hetch Hetchy Water Supply and Power Project showed, after allowing for operating costs, depreciation, and interest on debt, a rate of return of about 4 percent. Had the City invested an equal sum of about \$181 million in an insured savings and loan account, it would have realized a return of 5 percent, and if it had invested in some private business enterprise a return of 6 percent would have been very modest. The citizens of San Francisco can be said to be subsidizing the users of Hetch Hetchy water and power by at least the difference between 4 and 6 percent return or to the extent of \$3.5 million. In a market economy, all prices must include a factor for the use of capital. The amount of this factor depends on the existing alternatives. It is clear that, given a choice, San Franciscans could find a better use for their substantial public utility investments.

The five utility-type services provided by the City are water supply and power, transit services, roads and streets, the sewage disposal system, and airport services. With the exception of roads and streets, none of these systems is charging prices that cover full economic costs. Consequently, there seems to be a case for additional user charges; the degree of the increase, if any, depending not only on the bare financial facts, but also on other factors including future trends and social costs.

## Roads and Streets

While it is virtually impossible, or at least extraordinarily difficult, to make a direct charge for use of roads and streets,<sup>1</sup> it is now generally accepted by transportation economists that the user charge-principle should, with few reservations, be applied to public expenditures on roads and streets. The user charge is applied somewhat indirectly through state and Federal motor fuel taxes, state license fees, and Federal excise taxes. On an aggregate level, these sources support the vast majority of the nation's road and street expenditures.

On the local level, the picture is usually somewhat different. In a computation for 1957, William Vickrey found that in all United States cities \$2.9 billion was spent on roads and streets while users of those facilities paid only \$1.1 billion in user charges.<sup>2</sup>

A study for New York City revealed that on the average for the years 1957-1959 the City government spent \$36 million per year more on roads and streets than it received directly or indirectly from users. This sum represented 43 percent of its average annual road and street expenditures of \$84 million.<sup>3</sup>

But a study of San Francisco highway finances reveals a strikingly different picture. In fiscal year 1966, the highway user revenues to the City, as shown in Table 37, not only far outbalanced money outlays, but also provided a large enough surplus to provide a 4 percent return on investment and cover both a 2 percent amortization charge on highway investment and an estimated \$3.1 million property tax loss, i.e., the equivalent of what the City would have received were highway land devoted to businesses or residences.

TABLE 37

HIGHWAY USER REVENUES AND EXPENDITURES IN SAN FRANCISCO  
Fiscal 1966

	<u>Thousands of Dollars</u>
Users Revenues	\$22,915
Money Outlay on Roads and Streets	12,180
Total Economic Cost <sup>a</sup>	20,314

- a. Money outlay less capital outlay plus interest and amortization on capital investment plus estimated property tax loss.

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1. Except in the case of limited access facilities.

2. William W. Vickrey, "General and Specific Financing of Urban Services," in Public Expenditure Decisions in the Urban Community, ed., Howard G. Schaller, Resources for the Future, 1963, pp. 71-72.

3. Mark A. Haskell, "Highway Finance Policy in New York State and New York City," Financing Government in New York City (Graduate School of Public Administration, New York University, 1966), pp. 416-418.



The computation is a comprehensive one in that it includes, in addition to maintenance and construction of roads and streets, the costs of and revenues from parking facilities as well as traffic control costs and revenues from parking and traffic fines. Excluded because of lack of data are sanitation costs associated with motor vehicle use. This amount is not likely to be very large. However, the largest component in this category for American cities is snow removal expenditure. This, of course, does not exist in San Francisco.

The obvious conclusion here is that no case can be made for additional charges against motor vehicle use. It should be noted, however, that we have made no financial computations for the social costs of automobile use such as air pollution, street congestion, and noise. How a community chooses to deal with these problems is more a matter of planning than finance, but should at least be noted here.

### The Water Department

During the past five years, operations of the Water Department have resulted in an accounting net income figure averaging \$2.9 million per year. However, since capital costs, with the exception of bond interest, are not included in the calculation, the figure has no validity as representing the excess of revenues over expenditures. Table 38 converts the income data to net cash flow and shows that for four of the five years costs exceeded revenues, resulting in an average net cash outflow of almost \$3.3 million per year.

Another computation, Table 39, shows the true economic cost of water supply by substituting for current capital outlays a 6-percent charge representing interest on the value of facilities used. The difference between the 6-percent return and the accounting net income represents the true subsidy from taxpayers to users of water.

In either case, it appears that additional charges totaling \$3 to \$4 million per year would be appropriate to bring charges into line with the true costs of providing water. Since most consumers are in the City, the question may be academic whether in fact transferring these charges from the general tax rolls to water users would make any difference in the allocation of the costs between individuals and businesses as this depends on the allocation of the general tax burden compared to that of water charges.

Currently, owners of residential property pay about one-third of property taxes; after reassessment, this will rise to about 50 percent. In fiscal 1965-66 residential consumers used about 42 percent of all water consumed in the City and accounted for just over 50 percent of total revenue.

TABLE 38

SAN FRANCISCO WATER DEPARTMENT OPERATIONS  
Fiscal Years 1962-1966<sup>a</sup>

	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>AVG</u>
	(Thousands of Dollars)					
Net Income	4,762	3,028	4,314	4,434	2,897	3,887
Less:						
Bond Redemption	1,925	1,991	2,231	2,227	2,098	--
Less:						
Capital outlay other than from bonds	2,502	6,973	6,479	3,946	4,820	--
Net Cash Flow	335	-5,936	-4,396	-1,739	-4,021	-3,253

a. Years ended June 30th.

Source: City of San Francisco, Annual Report of the Controller.

TABLE 39

SAN FRANCISCO WATER SUBSIDY  
Fiscal Years 1962-1966<sup>a</sup>

	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>AVG</u>
	(Thousands of Dollars)					
Net Income	4,762	3,028	4,314	4,434	2,897	3,887
Total Investment beginning of year	114,837	117,411	119,931	124,808	140,892	123,576
Return on investment	4.1%	3.7%	3.5%	3.6%	2.1%	3.1%
Return at 6%	6,891	7,045	7,196	7,448	8,454	7,414
Assumed subsidy	2,129	4,017	2,882	3,054	5,557	3,527

a. Years ended June 30th.

Consequently, an upward adjustment of water rates so as to lower property tax contributions would not change the relative burden of businesses versus that of residential consumers to any appreciable degree. To the extent that the Department has customers outside the city, ample justification exists for a differentially higher rate for these customers. This would provide a modicum of relief for residential property owners.

There is a separate justification for raising water charges to the point where they cover the full cost of supplying the service. Prices act as a rationing device; *a priori*, the higher the price, the lower the consumption of a commodity. If water conservation ever becomes a problem, one way of conserving its use is to eliminate all subsidies connected with the service. On these grounds then, an increase in user charges could be justified.

### Sewer Charges

Except for some minor installation fees, the City makes no charges for the use of its sewage system. Currently, total money outlay less revenue is about \$3.36 million including capital costs, but not including depreciation charges. The true economic costs (less revenue), including only 4 percent interest on investment and depreciation charges of 2 percent, amount to almost \$8.1 million in the current fiscal year.

It is not typical for large cities to charge for sewage services by applying a percentage to consumers' water bills. There is some crude justice in this practice, the assumption being that a consumer generates sewage in proportion to his use of water. Were the City to apply charges totaling \$3 to \$4 million allocated on the basis of water charges, the proportional breakdown would be the same as that of the water charges themselves, i.e., 50 percent residential and 50 percent commercial and industrial, representing no change in the relative burden of owners of residences. That is, their sewer charges would be just offset by reduction in their property tax liabilities. Consequently, as in the case of water supply, nothing of substance in the way of shifting tax burdens could be accomplished by imposing user charges in this area. Nor need conservation be much of a concern since the use of the sewage system is roughly proportional to water use. Consequently, increased incentive to save water would automatically reduce use of sewage facilities.

### Hetch Hetchy Water Supply and Power Project

Table 40 presents financial data for the Hetch Hetchy Water Supply and Power Project using the same concepts as shown in Tables 38 and 39 for the Water Department.

TABLE 40

HETCH HETCHY PROJECT OPERATIONS  
Fiscal Years 1962-1966<sup>a</sup>

	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>AVG</u>
	(Thousands of Dollars)					
Net Income	2,507	6,026	6,590	5,064	7,461	5,530
Less:						
Bond Redemption	5,132	5,851	6,176	5,299	4,889	--
Less:						
Capital outlay other than from bonds	103	88	182	320	385	
Net Cash Flow	-2,728	87	232	-555	2,187	-755
Total Investment beginning of year	168,335	168,586	168,718	172,290	181,317	171,853
Return on investment	1.5%	3.6%	3.9%	2.9%	4.1%	3.2%
Return at 6%	10,101	10,115	10,123	10,337	10,879	10,295
Assumed Subsidy	7,594	4,089	3,533	5,273	3,418	4,765

a. Years ended June 30th

On the average, over the five-year period, 1962-1966, there has been a net cash outflow of \$775,000 for this project, but an actual cash surplus for 1966. Whether there is a trend of increased power sales and revenue so as to produce continuing surpluses cannot be deduced from this data. However, it is clear that in none of these years (except 1966) did net income constitute more than 4 percent of invested capital, with the average standing at 3.2 percent. Even in 1966, there was an assumed subsidy of \$3.4 million dollars from taxpayers to the users of electrical energy; that is, the users paid at least \$3.4 million less for the power they used than they would have paid under private operation. For the five-year period, the average subsidy was over \$4.7 million per year.

In contrast to the case of water supply where taxpayers and users are more or less the same persons, Hetch Hetchy customers are for the most part non-residents of the City. Consequently, were higher user charges instituted, there would accrue a net saving to City taxpayers virtually equivalent to the increased revenue from the higher user charges. On the basis of the data presented here, it would not be unreasonable to aim for an overall increase of \$3 million in revenue.

#### Airport Operations

As in the case of electric power generation, direct users of airline facilities are, to a marked degree, persons other than San Francisco residents. The owners of airline companies, airport restaurants, fuel supply companies, etc., can be assumed to be widely dispersed throughout the region, the state and the nation, as are the users of these facilities. Consequently, charges which represent less than the true economic cost of operating the airport facility represent also in large measure, income transfers from San Franciscans to non-residents. Even to the extent that the beneficiaries of the facility are residents, deficits would imply income transfers from low-income to high-income San Franciscans.

Table 41, which presents financial data for the airport operation, shows that there has been a steadily rising trend in net income to a 6.2-percent return on investment in fiscal 1966. The cash outflow of \$700,000 in that year is misleading since there was a heavy capital outlay of \$3.35 million from sources other than bond revenues. The 6-percent capital charge is a far more appropriate way of allocating capital costs overtime; it represents the cost of current use of existing facilities rather than future use of facilities newly completed or under construction.

As the basis of the 1966 data, it appears that the San Francisco Airport is charging appropriate fees; consequently, no increase should be recommended

at this time. But if the situation should revert to that of the years 1962 to 1965, approximately \$1 million in additional revenue would be appropriate.

TABLE 41

FINANCIAL DATA FOR SAN FRANCISCO AIRPORT

Fiscal Years 1962-1966<sup>a</sup>

	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>AVG</u>
	(Thousands of Dollars)					
Net Income	2,189	2,792	2,742	3,530	5,186	3,288
Bonds Redeemed	1,523	2,377	2,627	2,627	2,536	--
Capital Outlay other than from bonds	1,543	1,375	1,595	1,250	3,351	--
Net Cash Flow	-877	-960	-1,480	-347	-701	-873
Total Investment beginning of year	60,415	65,687	67,455	79,302	82,231	71,218
Return on Investment	3.6%	4.3%	4.1%	4.5%	6.2%	4.6%
Assumed Subsidy	1,436	1,149	1,305	1,228	0	1,029

a. Years ended June 30th

The Municipal Railway

Of all the utility-type operations of the City, the Municipal Railway is the least financially successful, showing a deficit in net income for each of the past five years (the period covered by this analysis). Moreover, this deficit has been growing steadily by about \$800,000 per year. Table 42 illustrates this and other financial data.

TABLE 42

FINANCIAL DATA FOR THE MUNICIPAL RAILWAY  
Fiscal Years 1962-1966<sup>a</sup>

	<u>1962</u>	<u>1963</u>	<u>1964</u> (Thousands of Dollars)	<u>1965</u>	<u>1966</u>	<u>AVG</u>
Net Income	-6,081	-6,808	-7,285	-8,043	-8,906	-7,425
Bonds Redeemed	1,535	1,535	1,102	142	0	
Capital Outlay other than from bonds	59	76	83	150	122	
Net Cash Flow	-7,675	-8,419	-8,470	-8,335	-9,028	-8,385
Total Investment beginning of year	31,707	31,173	31,761	31,592	31,617	31,678
Returns on Investment	0	0	0	0	0	0
Return at 4%	1,268	1,268	1,270	1,264	1,265	1,267
Assumed Subsidy	7,349	5,540	8,555	9,307	10,171	8,692

a. Years ended June 30th

But fare increases are not necessarily the answer to this financial dilemma, for virtually every fare increase in every large city has led to reduction in passengers carried and presumably increased use of private automobiles. Increasing automobile congestion and related noise and air pollution have led many communities to prefer carrying the cost of a transit deficit to greater social costs emanating from increased automobile usage. Consequently, we can see that, unlike the cases for other utility-type operations, there is some justification for the subsidization of transit services.

But whether the City should be quiescent in the face of mounting deficits is another matter. Passenger revenue has been remarkably stable in the past five

years, but operating costs have steadily increased and will continue to do so. In light of the fact that San Francisco has the lowest fare schedule of any major American city, as well as free transfer privileges, some charge, if only the elimination of the transfer privilege, seems to be called for. An immediate increase of about 10 percent in passenger revenues, or about \$2 million, seems reasonable under these circumstances.

However, mere subsidization of a constant level of service can hardly be called a serious counter-attack against the onslaught of the automobile. Total investment in the system has remained constant over the past five years, new capital outlay just offsetting depreciation. Under these circumstances, new riders are not likely to be won over to the system. The present approach of mounting deficits to maintain a stagnant system is, in the long run, self-defeating. A new approach coupling moderate fare increases with improved equipment and extended services should be seriously considered as an alternative.

## NON-UTILITY ACTIVITIES

### Health Service

While the costs of the majority of health service activities are properly chargeable against the general tax rolls in that they provide remedial services to low-income persons as well as disease prevention or control activities from which all benefit, some activities do, in fact, have identifiable beneficiaries who are, for practical purposes, the sole beneficiaries. Other health service charges result from the operation of businesses which require regulation in order to protect the health of the community and thereby incur inspection costs to the City.

### Emergency Hospital

An example of the former situation is the operation of Emergency Hospital, whose sole function is to provide emergency care, particularly to accident victims.

According to Health Department officials, this facility has traditionally been considered a "public health-oriented activity" and consequently has charged no fees. The idea of the Emergency Hospital is that those who need emergency treatment are "patched up" and directed to the proper facility if more extended treatment is necessary.



The facility operated at a cost of about \$1.1 million in fiscal 1966, and in the past six years has increased its expenditures at the rate of about 5 percent per year as shown in Table 43 below.

TABLE 43

TOTAL EXPENDITURES FOR EMERGENCY HOSPITAL

<u>Fiscal Year</u>	<u>Total Expenditures (\$ thousands)</u>
1961	820
1962	868
1963	953
1964	984
1965	1,019
1966	1,084

In the past, department officials have considered the imposition of fees, but have not followed through in view of the public service orientation mentioned above and also in view of the belief that collection and administration expenses would be very heavy if a fee system were initiated.

With the advent of Medicare, the Health Department has made calculations as to how Emergency Hospital is liable to fare financially if it is designated as an aided institution, and they have concluded that the City's contribution would be reduced.

The possibility still remains, of course, of setting up a billing system with the expectation that a good proportion of the fees will be paid by private medical insurance plans. The Department has tentatively concluded that such a system would not be productive when weighed against its costs, but with the knowledge that the costs of operating the unit will continue to mount, an intensive investigation of the problem would seem to be called for.

Perhaps a brief survey, say, over the course of a week, should be conducted to determine the extent of insurance coverage and gain some knowledge regarding income levels of those without coverage.

## Health Inspection

During fiscal 1966, the cost of milk and abattoir regulation and inspection, and food and sanitary inspection was \$930,000, excluding departmental overhead costs which would add approximately \$20,000 to that amount. At the same time, health inspection fees amounted to only \$161,000, leaving a deficit of almost \$800,000. On the grounds that businesses which require regulation should pay full inspection costs, there is a *prima facie* argument for quadrupling inspection fees. The counter argument based on the principle of *caveat emptor* would stress the responsibility of the consumer for his own safety and argue that the public should bear the cost of health inspection services. The case is not crystal clear, but a pragmatic judgment that the cost should be split would allow a doubling of existing health inspection fees so as to raise approximately \$400,000 per year.

## Building Regulations

In contrast to health inspection activities, the cost of building regulation and inspection appears to be more than offset by revenue from various permits, licenses, inspection fees and service charges. In fiscal 1966, cost to the City for these activities was about \$1.20 million, while offsetting fees totaled \$50,000 over that, or \$1.25 million. Consequently, no charge in these fee schedules should be recommended at the present time.

## Parks and Recreation

While the cost of the park system should be supported from the general tax levy on grounds of general, rather than specific, user benefit, the cost of many recreational activities should be borne by the users themselves.

No attempt is made here to analyze the balance between cost and revenue for each activity as in the Blyth Zellerbach Report of 1961. We would only say that those activities which are neither educational nor cultural in orientation nor used heavily by low-income persons should be fully supported by users. Some of those which have the characteristics noted above might charge nominal fees covering only a portion of the total cost of the activity.

Activities which should be subject to full charges representing at least current costs of operations are tennis and golf facilities, the Photography Center, the Industrial Athletic Division, Camp Mather, non-City activities in the three stadiums, Sharp Park Rifle and Archery ranges, and the Municipal Yacht Harbor,

with reduced rates or no fees at all for persons under the age of 18 or 14 years.

The only recreational facility which seems to have potential for substantially increased revenue is the San Francisco Fleishacker Zoo. The Blyth-Zellerbach Committee recommended a 75-cent admission fee for persons over 14 years of age and estimated that it would produce a net revenue of \$531,000, offsetting 1960-66 costs of \$451,000, with non-residents paying 75 percent of the admission fees.

The Elliott Report<sup>4</sup> raised the estimate of admissions from 1.5 million to 5.0 million persons per year. On this basis, it concluded that charging the 40 percent of the attendees over 18 years 75 cents for admission would raise \$1.5 million, less collection costs. This is probably something of an over-estimate, since the imposition of the entrance fee would undoubtedly reduce attendance levels.

Nevertheless, even a 50-cent attendance fee to those over 18 would seem able to raise \$800,000 per year, assuming a 20 percent drop-off in adult attendance. Such a charge is justified on the basis of practice in other cities, by the fact that the sole beneficiaries of this costly activity are the users themselves, and by the fact that the zoo is heavily patronized by non-residents.

#### Revenue Potential of User Charges

Table 44 summarizes the additional revenue-raising potential of the various activities discussed above.

TABLE 44

#### RANGE OF ADDITIONAL REVENUES FROM INCREASED USER CHARGES (thousands of dollars)

<u>Facility</u>	<u>Possible Increase</u>	
	<u>Low</u>	<u>High</u>
Water Department	3,000	4,000
Sewage System	0	3,500
Hetch Hetchy Water and Power Supply	3,000	3,000
Municipal Railway	2,000	2,000
Emergency Hospital	0	1,000
Health Inspection	400	400
Airport	0	1,000
Zoo	800	800
Total Additional Revenue	9,200	15,700

4. Virgil L. Elliott, "Report on Financing the Cost of San Francisco City and County Government," (San Francisco, November 1965—mimeographed).



## CHAPTER VIII

### FEDERAL AID: PROSPECTS AND OPPORTUNITIES

Tax-sharing may alter the pattern of American Federalism. The states, not the cities, have traditionally entered into direct partnership with the Federal government. However, the City of San Francisco has an exceptional opportunity to contribute to the molding of Federal tax-sharing legislation which will help insure that San Francisco will not be by-passed should massive Federal revenue redistributions now being discussed become reality. Also emphasized herein is the need for the City to consider the Federal government as a major revenue source in the years ahead. This need is viewed as a natural outgrowth of some of the past frustration which the City has experienced when trying to secure additional assistance from Sacramento. Unfortunately, the future cannot be termed any less uncertain in respect to state largess. Nor would it appear that the City may easily rely on its own tax sources in the years ahead as it has in the past. Bay Area "fiscal merchantilism", the product of a politically fragmented region, will undoubtedly serve to constrain local taxation, thereby preventing vitally needed programs from being adequately funded. If San Francisco chooses to remain one of the most cosmopolitan and urbane cities in the United States, some difficult choices lie ahead. One of these choices may involve greater contact with the Federal government.

#### CLOSER FEDERAL-CITY RELATIONS

A new era in Federal-City relations is fast approaching. While present Federal assistance programs provided the City of San Francisco with barely \$3 per person<sup>1</sup> in direct aid, the advent of the poverty program, Demonstration Cities, and Medicare have already served to bring San Francisco and Washington closer together. This is happening despite the fact that certain programs calling for direct contact, e.g., Demonstration Cities, have been found wanting in one respect or another by the City's leaders and have recently been shelved. In all probability, future events will dwarf existing opportunities for Federal-City cooperation. Politicians of all persuasions have endorsed a distribution of Federal funds to state and local governments by such devices as tax-sharing, tax credits, block grants, and tied grants-in-aid.

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1. Calculation derived from U. S. Bureau of Census, City Government Finances, 1964-65.



Considerable disagreement exists, however, over the merits of the various devices and the advisability of including a "pass-through" provision in the law which would insure that cities directly receive large Federal cash disbursements without interference or interception by state officials. The states have long contended that the nature of American Federalism dictates that it is the states, not local governments, that should act in any partnership with Washington. Cities, the legal creatures of the state, must have their Federal funds first channeled through state offices, according to this historically correct viewpoint. Over the years, however, our nation's cities have felt themselves short changed by state legislatures that frequently over-represent rural interests. It is hardly surprising to note, therefore, the aggressiveness with which some big-city mayors have pursued direct Federal-City relationships and have rejected the idea of tax-sharing restricted to the Federal-state partnership.

One may conclude that as the City's needs have risen it has had to rely increasingly on its own revenue sources to underwrite the budget. Indeed, the City is still demonstrating a strong appetite for funding an even larger number of programs from its own resources. Recently, for example, when the Governor announced that two state-run mental health programs in San Francisco were to be discontinued as part of a meat-axe reduction of appropriations for mental health throughout the state, the City's instinctive response to this cut-back was to push for a continuation of these programs under the aegis of the local Health Department. Despite the laudable efforts of the City to increase the level at which local functions are performed, it is apparent that there is still considerable opportunity to enrich the quality of City programs, and that pressures to increase expenditures will continue to persist at least into the coming decade.

One strains to imagine how San Francisco could virtually double expenditures in the next decade by means of its own revenues. It is reasonable to believe that City expenditures will continue their upward trend even if the rate of increase shown in the last decade tapers off somewhat. As the City of San Francisco declines in political importance in Sacramento, serious questions will arise over

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2. Recently, a number of mayors expressed concern that tax-sharing proposals now before Congress would result in the states' intercepting funds needed by the city. Mayor John F. Collins of Boston, a member of this group, testified before Senator Muskie's Senate Subcommittee on Intergovernmental Relations that because of this problem, "tax-sharing is the most dangerous idea in America today." See The New York Times, February 7, 1967.

the City's ability to pressure or cajole the state into increasing San Francisco's share of state assistance to local governments.<sup>3</sup> At best, a great deal of uncertainty surrounds this problem, and the City's decision-makers cannot always depend upon the State House to be responsive.

Does the City have the capacity to fund massive revenue needs from its own sources? While this study was not charged with the responsibility of making long-run projections of City expenditures and revenues, it is reasonable to suppose that they will increase more rapidly than will the City's existing tax base. It is almost axiomatic that local government expenditures grow more rapidly than does the local economy. In part this is a reflection of an increasing taste for public goods by city-dwellers who want better schools, cleaner air, improved street illumination, a more effective police force, rapid transit, increased local transportation, etc. This phenomenon is representative of what Walter Heller has termed "the whiplash of prosperity"--responsibilities out-strip revenues.

Another factor not to be overlooked is the continuous pressure placed on public expenditure levels by increases in the prices of the "inputs" of the governmental process. Unfortunately for taxpayers, the purchasing power of their tax dollars has declined even more rapidly than it has for their own private needs. That is, the consumer price index increased about 12 percent between 1958 and 1966, while the implicit price deflator appropriate to the government purchase of goods and services increased more than 20 percent. Nor is this the only evidence of creeping inflation. A recent study of New York City expenditures by Gerald J. Boyle showed that in New York City, the cost of personal services for public education increased by almost 60 percent between 1956 and 1966.<sup>4</sup>

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3. The relative decline of San Francisco related to population in the Bay Area is quite dramatic. In 1950, the San Francisco population was 775,357, or 28 percent of a combined population for Alameda, Contra Costa, Marin and San Mateo and San Francisco counties of 2,135,934. By 1980, the State Department of Finance expects San Francisco to have about the same population as it presently does, but the area population will have swollen to 4,212,900. This will leave San Francisco with only 15 percent of the area's population.
  4. Gerald J. Boyle, "Projections of New York City Expenditures to 1975," Financing Government in New York City (Graduate School of Public Administration, New York University, 1966).



Boyle's research suggests that urban communities are paying much more to hold and attract teachers, programmers, social workers, and other skilled workers than they had suspected. City government is a labor-intensive enterprise and it seems probable that this condition will continue into the future. San Francisco must bid aggressively with other cities and private enterprise for such skills unless it chooses to accept even worse public education, less police protection, and generally inferior performance of urban services. Alternatively, it could substitute capital for labor by launching a campaign to mechanize city government as fully as modern technology will allow. Such a campaign conceivably could forestall substantial demands for new revenues over the long term.

Whether the City's tax base will actually increase as rapidly as does the local economy is a difficult question to answer. Even if we were to assume that the property tax base, which accounts for seven-eighths of local taxes, were responsive to changes in the local economy, that is, if it were a tax base of unitary elasticity in respect to income (a doubtful assumption at best), there would still be a revenue "gap" since City expenditures will probably rise at a faster rate than income.

Moreover, the rest of the City's tax base is a mixed bag of sales taxes, licenses, and fees. Of these, only the sales tax can be relied upon to keep reasonably abreast of changes in economic activity. One may conclude, therefore, that it will require more in the way of rate changes and imposts to fund growing budgets.

### FISCAL MERCANTILISM

The City of San Francisco is a peninsula surrounded by communities anxious to lure San Francisco commerce and industry out of the City into the satellite ring. Their competitiveness are aggressiveness are bound to achieve some success should San Francisco taxes rise faster than their own. While it may be reasonable to suppose that certain Bay Area communities may be under even greater pressure to raise taxes than San Francisco, and therefore will not present a tax threat to the City, other communities that are not experiencing revenue problems will constrain tax rate increases throughout the area. Caught in this fiscal cross-fire, San Franciscans will approach new taxes timorously during the coming years. Barring any great changes in government in the Bay Area, such as the advent of regional or metropolitan government, an event which would certainly mitigate rampant fiscal mercantilism, the City of San Francisco

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5. See Chapter II for a discussion of Bay Area tax rates and problems.

must be prepared to turn increasingly to Federal devices for returning taxes to localities. The following discussion is designed both to present some basic concepts around which future legislation will be constructed and a few examples of plans now being considered.

#### PLUGGING THE REVENUE GAP WITH FEDERAL FUNDS: SOME ALTERNATIVES

Unlike the tax machinery of local government which often fails to produce tax revenue as fast as the local economy rises, the Federal government is custodian of a remarkable apparatus built around taxes that include both a steeply progressive personal income tax and a tax on corporate profits. When GNP rises, Federal tax revenue rises even more rapidly. In order to prevent a too-rapid increase in Federal government receipts (currently an unlikely situation due to heavy Defense Department requirements), a phenomenon that could run the budget into surplus and thereby generate a "fiscal" drag of unemployed resources, it was proposed that the Federal government redistribute this potentially disturbing balance of funds to the states who would presumably then spend these funds on needed programs. This was the kernel of the idea for the original Heller Plan. Some observers, however, saw in the Heller Plan a means by which the states could cut taxes, a most undesirable consequence of any redistribution. Others believed that the states would spend the funds on unnecessary or irresponsible programs and projects. Still others, including Senator Muskie,<sup>6</sup> believed that tax-sharing would not bring extra funds to the places where they are needed most - our nation's cities.

This last issue is certainly the most important for San Francisco. It is the one to which San Francisco must turn its attention in order to insure that future legislation contains an adequate pass-through provision. The following list contains the general types of grants which would be appropriate for the City, provided they contained this needed pass-through proviso.

- Block Grants: These grants allow the State to receive funds unconditionally or with a minimum of conditions. The Heller Plan features block grants which would distribute \$6 billion annually based upon a fixed 2 percent rate to be applied against the Federal income tax base. The funds collected would be allocated to the states based upon a per capita income allocation of say 10 or 20 percent of the total amount. The Heller proposal does, however, ask for minimal restrictions on the ways in which states may spend their grants (e.g., prohibits their use for highway purposes).

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6. As quoted in The New York Times, February 10, 1967.

- **Tax Sharing:** Under this plan a portion of certain federal revenues would be returned to the states on the basis of their source of collection. The Republican Party has officially adopted this device. Among the current bills incorporating this concept are:
  - S. 3405 (Messrs. Miller, Allott, Fannin and Scott) which uses total federal tax collections as the base and allocator;
  - H.R. 15557 (Mr. Andrews of N. Dakota) which would return federal taxes for educational purposes only;
  - H.R. 1527 (Mr. Bray) that would use cigarette tax collections as the allocator.
- **Tax Credits:** Under this plan taxpayers could deduct a portion of their state and local taxes from their Federal tax bills. This plan is unusually appealing to local government since the Federal government would be underwriting a portion of local tax bills, thereby allowing a higher local rate than would otherwise be possible. Eugene Nickerson, Nassau County Executive, has recently proposed that homeowners and apartment renters be allowed to deduct part of their local property taxes from both federal and state income taxes. Under Nickerson's plan, a homeowner could claim as a tax credit 80 percent of his taxable net income (but not more than \$400). Three fourths of the credit could be claimed against the Federal income tax, one fourth against the state income tax. Renters could also make this computation assuming that a fixed percent of their rent, say 25 percent, represents forward-shifted property taxes. (Other interesting variations will surely occur to those interested in dividing the Federal pie and securing a good-size piece of it for our nation's cities.)
- **Tied Grants:** This is a more traditional approach to the disbursement of Federal funds. It has been frequently alleged that tied grants create budgetary distortion at both the state and local levels because they involve matching. Recipients claim that they must take appropriations for programs they might otherwise not be involved in simply because they "lose" Federal funds. Furthermore, expansion of the present system of tied grants elicits hostile

reactions from governors and other state officials who are attempting to preserve the sovereignty of the state. At a governor's panel at the recent American Association for Public Administration, several governors, including California's ex-governor, Edmund G. Brown, were reported to view increasing federal grants with great trepidation. From San Francisco's viewpoint, tied grants can cut both ways -- that is, they are usually channeled through the state, thereby paving the way for limited misallocation by state officials. Nevertheless, cities may still be much better off under this system than they might be if the states were to intercept unconditional block grants and then determine how the funds were to be allocated.

This question will undoubtedly be one of the major issues of the 1970's, and our nation's cities must be prepared to answer it if they are to retain their present governmental structures. (For one expert's appraisal of the effects of alternative methods of aid to states and localities see Table 45.)

### PUBLIC SUPPORT

A recent Gallup Poll has demonstrated that tax sharing is a popular concept. Americans, irrespective of sex, ethnic background, income, or political persuasion are overwhelmingly in favor of revenue sharing in principle. (See Table 46.) When asked if 3 percent of Federal tax revenue should be returned to the states and local governments to be used by those governments as they see fit, 70 percent of those asked responded favorably. It is very probable that the people of San Francisco would also respond with favor.

### WHAT THE CITY CAN DO

While it is clear that San Francisco cannot look to a "Heller Plan" to solve its immediate revenue problems, it can formulate an intelligent position vis-a-vis future legislation in this area. At present, politicians are somewhat confused by the proliferation of proposals to share federal surpluses and by the conflicting testimony of various congressmen, governors, ex-governors, mayors and other interested persons. Thus, it is a propitious time for San Francisco to:

- Decide just how it would wish to participate with the Federal government;
- Expend energy and political "capital" in selecting an acceptable "pass-through" device which would insure the City a fair share in any future distribution of federal funds;
- Mobilize its political resources in a concerted drive to shape the legislation which is bound to be passed in the next few sessions of Congress.

TABLE 45

AN APPRAISAL OF THE EFFECTS OF ALTERNATIVE METHODS  
OF FEDERAL AID TO STATES AND LOCALITIES

<u>Financing Method</u>	<u>Direction of Effects</u>				
	<u>Federal Role In Economy</u>	<u>Federal Influence on States</u>	<u>Tax Progres- sivity</u>	<u>Built-In Stabilizers</u>	<u>Role of Cities</u>
1. Direct Federal Programs	↑	→	→	→	→
2. Tied Grants	→	↑	→	→	→
3. Block Grants	→	→	→	→	↓
4. Tax Credits	→	→	↓	↓	→
5. Tax Sharing	→	→	↓	↓	↓
6. Federal Tax Reduction	→	→	↓	↓	→

Legend:            ↑ = Increase                    → = No Change            ↓ = Decrease

Source:    Murray L. Weidenbaum, "Innovations in State and Local Government Finance," A presentation to the Mayor's Seminar, Washington University, St. Louis, Missouri, May 18, 1966 (mimeographed).

TABLE 46

PUBLIC RESPONSE TO TAX SHARING

(Gallup Poll)

(Question: "It has been suggested that 3 percent of the money which Washington collects in Federal income taxes be returned to the States and local governments to be used by these State and local governments as they see fit. Do you favor or oppose this idea?")

(In percent)

		January 1967		
		Favor	Oppose	No Opinion
National		70	18	12
Sex:	Men	70	20	10
	Women	69	16	15
Race:	White	71	19	10
	Nonwhite	X	X	X
Education:	College	68	27	5
	High school	71	18	11
	Grade school	69	10	21
Occupation:	Professional and business	69	23	8
	White collar	65	24	11
	Farmers	83	13	4
	Manual	70	15	15
Age:	21 to 29 years	66	20	14
	30 to 49 years	70	20	10
	50 and over	71	14	15
Religion:	Protestant	72	16	12
	Catholic	66	19	15
	Jewish	X	X	X
Politics:	Republican	72	20	8
	Democrat	69	15	16
	Independent	69	22	9
Region:	East	64	20	16
	Midwest	73	21	6
	South	74	11	15
	West	65	20	15
Income:	\$10,000 and over	68	25	7
	\$ 7,000 and over	70	21	9
	\$ 5,000 to \$6,999	76	14	10
	\$ 3,000 to \$4,999	67	15	18
	Under \$3,000	65	15	20
Community Size:				
	1,000,000 and over	57	20	23
	500,000 and over	62	20	18
	50,000 to 499,999	71	21	8
	2,500 to 49,999	68	21	11
	Under 2,500, rural	79	11	10

Source: Reproduced from Congressional Record, 90th Cong., 1st ss., February 15th.

## CHAPTER IX

### EXEMPTIONS FROM PROPERTY TAXATION

#### TYPES OF EXEMPTIONS

Much of the City's property is tax exempt. Exemptions are traditional, and were created in order to satisfy public policy objectives in the political, economic and social realms. The City itself is custodian of almost 5.4 million acres of tax-exempt land located within its own boundaries. The value of this land is estimated at more than \$575 million.<sup>1</sup> In addition, the State and Federal governments own additional thousands of acres of tax-exempt property within the City. Most would agree that this type of exemption can be readily justified because all three levels of government perform a wide range of services benefiting San Franciscans.<sup>2</sup> Other exemptions have been granted private owners of property. Frequently exemptions of this type, e.g., church, welfare, college, etc., have been made to encourage the use of property for the provision of services which some level of government would otherwise be forced to provide. Still a third type of exemption confers special privilege, e.g., the veteran's exemption, and has been created or sustained in response to political pressure. Finally, an exemption may be granted in those cases where either the costs of tax collecting for a public agency or the compliance costs for the taxpayer are so excessive that enforcement of the law would be unrewarding. An example of such an exemption is the householder's exemption which effectively exempts a significant portion of the residential personal property tax roll.

#### ABUSES OF PROPERTY-TAX EXEMPTIONS

It has been alleged on occasion that organizations enjoying some of these exemptions carry on commercial activities under the "umbrella" of the exemption. It is true that an organization such as a college or church that owned, say, a bakery would hold a competitive edge over its commercial rivals. However, discussions with various public officials in San Francisco and Sacramento failed to lend substantial credence to this charge.

1. City and County of San Francisco, Director of Property, Valuation of Real Property Owned by City and County of San Francisco. This estimate is probably an understatement of its current market value.
2. In certain cases, however, use of land by one of these public bodies (e.g., a military post) may not primarily benefit local residents, and an injustice would be created since the land could either be put to some other more profitable and private (tax-paying) use, or could be owned by another public agency in order to provide services for San Francisco.

The state has the responsibility for determining what constitutes a non-profit organization. Even so, possible loopholes appear; e.g., the state itself does not attempt to clarify that a particular religious group represents a bona fide religion. Those who would contend that this could open the door to associations who might abuse tax exemptions are probably overly cautious. In practice, the state does keep track of whether income stems from essentially non-profit or from ordinary business endeavors. Barring a detailed and costly study of the corporate structure and activities of every organization enjoying a tax exemption in San Francisco, it is safe to conclude that the number of organizations enjoying exemptions for property used for commercial or industrial purposes is small and will remain so under SBE surveillance.<sup>3</sup>

Those organizations which are tax exempt but which do pursue limited commercial objectives are taxable on that part of their property which is traceable to such activities. The problem of property tax exemptions is not one with which the Board of Supervisors may deal directly, even if abuses were a real threat to the tax base. That is, they do not have discretionary power to grant or deny exemptions since this is legally a state-mandated function. It is clear, however, that the general problem of property tax exemptions is one which merits continued discussion since some confusion exists over their true long-run significance for the community. The following discussion of the significance of property tax exemptions includes only those which have been recorded by the Assessor and reported to the State Board of Equalization (SBE). Unfortunately, no reliable information exists concerning the value of Federal and State government property, and its appraisal would be difficult and costly.

### THE CURRENT SITUATION, A COMPARATIVE ANALYSIS

Last year, tax exemptions enjoyed by private individuals and corporations narrowed the property tax base of San Francisco by over \$121 million. This represents not only about \$95 million in exemptions reported by the Assessor to the SBE, but also another \$26.7 million in exemptions for household property that never appeared on the City tax roll. Table 47 shows that San Francisco has the highest ratio of property tax exemptions to the property tax base of any county included in this study. Well over 5 percent of its base has been eroded; the other counties display fiscal 1966 ratios ranging from 2.9 in less urbanized Contra Costa to 4.4 in more urbanized Alameda County.

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3. AB 80 has tightened the reins which the state has over exemptions. It requires irrevocable dedication of property to be in the archives of incorporation. To qualify for welfare property tax exemption an organization must be exempt under both Corporation Tax Law and the Internal Revenue Code. Under AB 80 the State Board of Equalization will be the final arbiter of an organization's eligibility. (Up to now the local assessor exercised a great deal of discretion in this area.)



TABLE 47

## ASSESSED VALUE OF PROPERTY TAX EXEMPTIONS: SELECTED COUNTIES

FISCAL YEAR 1962-1966  
(dollars amount in thousands)

County and Exemption	1962	1963	1964	1965	1966	Percentage Change 1962-66
<u>Alameda</u>						
Total Value	\$84,414	\$79,873	\$80,459	\$82,143	\$83,890	- .67
Total Value as percent of base	5.4	4.9	4.6	4.5	4.4	-18.5
Veterans	\$50,697	\$43,213	\$40,388	\$39,367	\$36,622	-27.8
Church	12,658	13,261	14,580	15,673	15,677	23.8
College	4,428	4,579	4,598	5,012	5,566	25.7
Welfare	16,631	18,820	20,893	22,091	26,025	56.5
Schools	4,107	4,420	4,734	5,110	5,700	38.7
Hospitals	7,791	9,333	10,140	10,727	11,506	47.7
Other	4,733	5,067	6,019	6,254	8,819	86.3
<u>Contra Costa</u>						
Total Value	\$42,791	\$40,516	\$38,047	\$38,737	\$39,535	- 7.6
Total Value as percent of base	4.4	3.9	3.4	3.2	2.9	-34.1
Veterans	\$32,222	\$28,644	\$25,079	\$23,446	\$21,896	-32.0
Church	6,278	7,102	7,984	8,773	9,254	47.4
College	1,248	1,272	1,287	1,803	1,833	46.9
Welfare	3,043	3,478	3,697	4,715	6,552	115.3
Schools	1,441	1,665	1,798	1,890	2,676	85.7
Hospitals	839	1,035	1,107	1,959	2,967	253.6
Other	763	778	792	866	909	19.1
<u>Marin</u>						
Total Value	\$17,595	\$16,816	\$16,239	\$16,519	\$17,339	- 1.5
Total Value as percent of base	6.0	5.1	4.3	3.8	3.6	-40.0
Veterans	\$ 9,429	\$ 7,459	\$ 6,488	\$ 5,725	\$ 5,178	-45.1
Church	1,896	2,178	2,381	2,778	3,053	61.0
College	2,766	3,075	3,110	3,341	3,758	35.9
Welfare	3,504	4,104	4,260	4,675	5,350	52.7
Schools	2,026	1,927	1,970	2,589	2,942	45.2
Hospitals	84	86	88	86	87	3.6
Other	1,394	2,202	2,202	2,000	2,321	66.5

TABLE 47 (Continued)

County and Exemption	1962	1963	1964	1965	1966	Percentage Change 1962-66
<u>San Francisco</u>						
Total Value	\$85,138	\$86,255	\$88,897	\$92,019	\$94,666	\$11.2
Total Value as Percent of base	5.6	5.5	5.4	5.4	5.4	- 3.6
Veterans	\$26,163	\$24,847	\$23,482	\$22,625	\$21,532	-27.7
Church	17,015	17,581	19,511	20,285	20,975	23.3
College	3,057	4,177	4,563	4,883	5,823	90.5
Welfare	38,903	39,650	41,341	44,276	46,336	19.1
School	10,533	10,848	11,756	12,164	13,074	24.1
Hospitals	17,678	17,890	18,674	20,468	22,019	24.5
Other	10,692	10,912	10,911	11,644	11,243	5.2
<u>San Mateo</u>						
Total Value	\$48,320	\$46,621	\$46,416	\$44,986	\$46,009	- 4.8
Total Value as Percent of base	5.2	4.7	4.4	3.2	3.1	-40.4
Veterans	\$32,821	\$29,895	\$28,064	\$20,153	\$17,523	-46.6
Church	6,101	6,637	7,115	10,055	10,765	76.4
College	2,966	3,058	3,520	4,679	4,645	56.6
Welfare	6,432	7,031	7,717	10,099	13,076	103.3
Schools	3,727	3,893	4,077	5,349	5,523	48.2
Hospitals	842	1,160	1,403	3,084	3,958	370.1
Other	1,863	1,978	2,237	1,666	3,595	93.0

Source: California State Board of Equalization, Annual Reports, fiscal year 1962-66.

The significance of this disparity is difficult to measure, particularly because assessing practices may differ among these counties. It is well known that where property is not subject to taxation, assessments may be unrealistic. These findings do, however, appear to support the view that certain types of exemptions are related to the degree of urbanization within an area. As urbanization increases the proportion of property devoted to churches, colleges, schools, etc., tends to rise. These institutions may be looked upon as being vital to a great cosmopolitan center and may well be one measure of the difference between urban and rural living. Just as we might find a higher concentration of service-oriented businesses in cities, so we may find a higher concentration of service-oriented non-profit institutions.

Our data (Table 47) suggest that exemptions are not rising as quickly as is the tax base in San Francisco. In 1962, exemptions accounted for 5.6 percent of the base; they have dropped to 5.4 percent in 1966. This relative decline is largely attributable to the decline in the importance of Veterans' exemptions. In 1962, Veterans' exemptions amounted to \$26 million. By 1966, they had dropped to almost \$21.5 million, a net decline of 28 percent.<sup>4</sup>

#### A GENERAL APPRAISAL

Property tax exemptions are a mixed blessing. They may be desirable on a number of ethical, social, and political grounds. They do lead, however, to significant erosions of the tax base. Moreover, assessment practices become casual and relaxed in respect to exempt property. As a result, society at large receives a set of false indicators regarding the true cost of maintaining this elaborate system of exemptions. Usually, the true cost of exemptions is understated since market forces tend to influence assessment practices, at least in the long run, for taxable property. For non-taxable property this situation is usually reversed; as time passes, assessment of exempt property becomes poorer since the assessor has little incentive to spend his time reassessing property which is off the roll.

There is one final point which can be made regarding exemptions. Because of the unusual problem confronting the City, exemptions may be defended on the ground that since they largely affect "residential" property rather than

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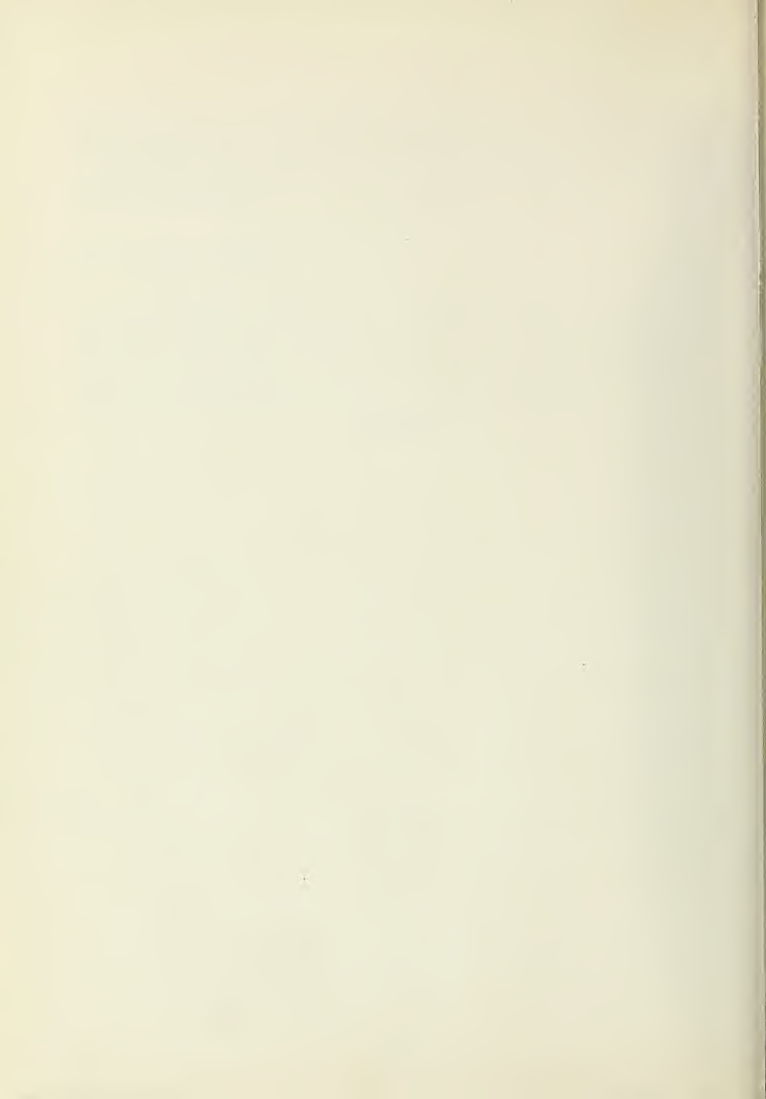
4. Charges have been made that certain homeowners receive the Veterans' exemption only because they understate the value of their assets. There are many indications that such abuse exists, but more realistic verification of value of assets by the Assessor's office would be very costly. This single source of inequity constitutes grounds for a complete re-evaluation of this exemption by the State.

industrial and commercial they constitute a counter-balance to the reassessment-engendered tax shift. Although these exemptions may be distributed haphazardly among City households, they do shrink residential tax liabilities. This phenomenon may offset the usual arguments against such exemptions, at least under present circumstances.

#### WHAT THE CITY CAN DO

Regrettably, the City has almost no discretion in respect to controlling exemptions. What it can do, however, is to insure that exempt property is periodically reappraised so that the City's residents will know the true significance of these exemptions. In respect to exemptions administered through the Assessors office, maximum diligence must be maintained to insure that only those who truly qualify for these exemptions will receive them.

## APPENDICES



## APPENDIX A

### ASSESSING THE IMPACT OF REASSESSMENT ON THE SAN FRANCISCO HOUSING STOCK

#### DATA BASE AND METHODOLOGY

The ideal approach to developing the information desired in this report would be to make a comprehensive survey of the dwelling units and residents in San Francisco. Unfortunately, such an approach could not be fitted into the time and budget constraints of the present contract. Therefore, the most comprehensive source of presently available data--the 1960 Census of Housing was used. Extensive computer-based analytical manipulation of census data permitted the breaking out of population subgroups on the basis of the kinds of dwelling unit occupied. Census data on housing rent or value were combined with capitalization rates computed by Arthur D. Little Inc., for each category of household.

The existing tax on all of the dwelling units was estimated from assessment practices. These estimates were made after several discussions with representatives of the Assessor's office and a review of the material discussed in Chapter I of this report. A computer program was then written to simulate the impact of the tax change under the assumption of a uniform assessment ratio of 25 percent. Also simulated was the impact of the present tax rate of \$10.61 per \$100 of assessed valuation and a new rate of \$8.90 per \$100 of assessed valuation. Next, estimates were made of the change in housing costs to the various households and dwelling unit value changes that follow the tax clue to reassessment.

The breakdown of the population into household groupings was based on the nature of the available data and the desire to develop household groupings that will be meaningful in terms of the housing market, i.e., household groupings having similar housing needs or demands. While the data used all stem from the 1960 Census, available breakdowns were more extensive than would have been possible had not material developed from the Community Renewal Program been available. The City's population was broken down into the following 15 groups:

Household DesignationDescription

1	White; no children; income between 0 - \$4, 000
2	White; no children; income between \$4 - 8, 000
3	White; no children; income between \$8 - 15, 000
4	White; adult and children; income between 0 - \$4, 000
5	White; adults with children; income between \$4 - 10, 000
6	White; adults with children; income between \$10 - 15, 000
7	Oriental & Other; no children; income 0 - \$4, 000
8	Oriental & Other; no children; income between \$4 - 8, 000
9	Oriental & Other; adults with children; income be- tween 0 - \$5, 000
10	Oriental & Other; adults with children; income be- tween \$6 - 12, 000
11	Negro; no children; income between 0 - \$4, 000
12	Negro; no children; income between \$4 - 8, 000
13	Negro; adults with children; income between 0 - \$4, 000
14	Negro; adults with children; income between \$4 - 8, 000
15	Negro; adults with children; income between \$8 - 12, 000

The City's housing stock was divided into nine structural types and three condition classes. Condition 2 includes housing that has been defined as "standard" by the Bureau of Census. Condition 3 corresponds with the Census condition "deteriorating" plus "standard with plumbing lacking." Condition 4 corresponds with the Census definitions of "dilapidated" and "deteriorating with plumbing lacking." The nine structural types are defined in Table A-1.



TABLE A-1

STRUCTURAL CATEGORIES USED AND CAPITALIZATION RATIOS APPLIED

<u>Housing Type</u>	<u>Structure</u>	<u>Number of Rooms</u>	<u>Capitalization Ratio</u>
1	Single family	1-4	7.5%
2	Single family	5-6	7.5
3	Single family	7+	7.5
4	2-4	1-4	8.5
5	2-4	5+	8.5
6	5+	1	10.5
7	5+	2	10.5
8	5+	3-4	10.5
9	5+	5+	10.5

A detailed survey of real estate sales in San Francisco had been conducted while Arthur D. Little, Inc., was doing research for the Community Renewal Program.<sup>1</sup> This survey provides capitalization or yield rates that pertain to the various structural types. These capitalization rates are indicated on Table A-1 and were used to estimate implicit or imputed rents for owner-occupied dwelling units by dividing the capitalization rate into the values indicated by the 1960 Census of Housing. The capitalization rates were also utilized to estimate initial values for renter occupied units where Census data provided estimates of rents paid by the various household groups for each structural type by condition.

Total taxes paid on each kind of dwelling unit were estimated by utilizing best-judgment approximations concerning the present ratio of assessed to appraisal value, and multiplying the value calculated with the use of Census data and the previously stated capitalization rates by these assessment ratios and the current tax rate of \$10.61 per \$100 of value. While our study of present assessment ratios indicated that it would have been more accurate to apply differing assessment ratios to each structural type broken down still further

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1. "Variation in Rates of Return," L. K. Loewenstein and R. Recht, *Appraisal Journal*, April 1965.

by age, no age breakdown was undertaken and the following average assessment ratios were used:

For all single-family structures	10%
For all houses with 2-4 dwelling units	14%
For all structures with more than 5 dwelling units	20%

The methods, data base and assumptions used in this simulation of existing and new taxes do not lend themselves to any exact comparison with assessment records. First, all of the Census data used is seven years old; and second, all of the Census-based data would have had to be adjusted by means of a detailed comparison with assessment records if comparability were desired. However, this analysis is aimed at developing numbers that can be used in a judgmental evaluation of the tax impact.

The new tax rates used were calculated by means of an independent determination of new tax requirements and SBE data on the property tax base. (See Chapter I.) Therefore, the new tax rate of \$8.90 per \$100 may not reflect the actual new rate that is applied.

The reader should be aware of the strength of this data as well as its weaknesses. The errors that have been introduced fall equally upon both the household groups and the structural types that are analysed. Therefore, this approach can be relied upon to express the relative differences that will result from the change in tax practices that will be induced by the implementation of AB 80.

APPENDIX B

HOUSING CONSTRUCTION/DEMOLITION RECORD, 1960-1965,  
BY TYPE OF STRUCTURE (NUMBER OF UNITS)

NEW CONSTRUCTION 1960-1965

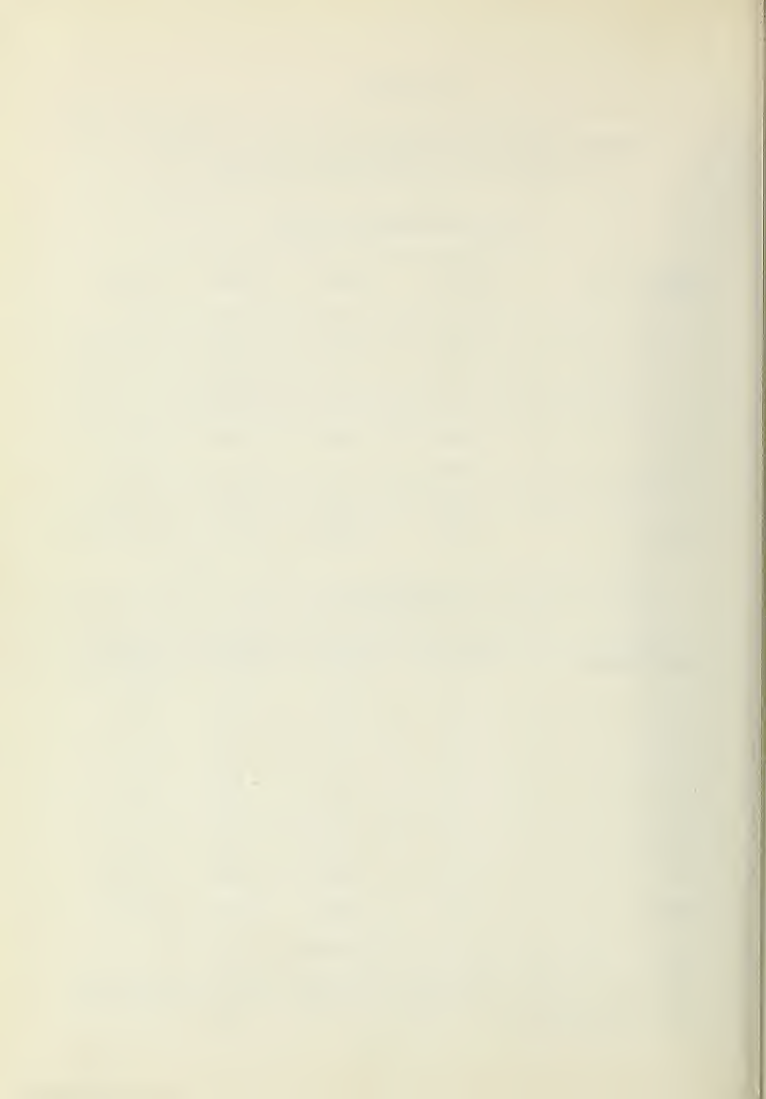
<u>Units/Structure</u>	<u>Structures Number</u>	<u>Percent</u>	<u>Units Number</u>	<u>Percent</u>
1	3,106	62.0	3,106	15.4
2	408	8.1	816	4.1
3	60	1.2	180	0.9
4	305	6.1	1,220	6.0
5-9	654	13.0	4,319	21.4
10-19	355	6.9	4,624	23.0
20+	<u>113</u>	<u>2.2</u>	<u>5,873</u>	<u>29.2</u>
TOTAL	5,012	100.0	20,138	100.0

DEMOLITION

<u>Units/Structure</u>	<u>Structures Number</u>	<u>Percent</u>	<u>Units Number</u>	<u>Percent</u>
1	1,153	63.7	1,153	31.4
2	352	19.4	704	19.2
3	111	6.1	333	9.1
4	48	2.6	192	5.2
5-9	107	5.9	707	19.3
10-19	32	1.8	391	10.7
20+	<u>7</u>	<u>0.8</u>	<u>187</u>	<u>5.1</u>
TOTAL	1,810	100.0	3,667	100.0

Source: San Francisco Department of City Planning, January, 1967.

Taken from "A Report on Housing in San Francisco," May, 1967, prepared for Mayor John Shelley by the Inter-Agency Committee on Urban Renewal, City and County of San Francisco.



## APPENDIX C

### INCOME TAX DATA AND ESTIMATES

TABLE C-1

ESTIMATE OF ALTERNATIVE BASES FOR TAX ON INCOME  
EARNED IN SAN FRANCISCO, 1967

TYPE I INCOME BASE<sup>a</sup>

	<u>Residents</u>	<u>Commuters</u>	<u>Total</u>
	(Thousands)		
I. <u>A.G.I. (Adjusted Gross Income)</u>			
Wages and Salaries	\$1, 454, 000	\$1, 267, 000	\$2, 721, 000
Proprietors Income	257, 000	222, 000	479, 000
Total	1, 711, 000	1, 489, 000	<u>3, 200, 000</u>
II. <u>A.G.I. less \$600 per capita exemption (77% of A.G.I.)</u>			
Wages and Salaries	1, 120, 000	976, 000	2, 096, 000
Proprietors Income	198, 000	171, 000	369, 000
Total	1, 318, 000	1, 147, 000	<u>2, 465, 000</u>
III. <u>A.G.I. less State Exemptions</u> ("II" less \$900 x 63, 000 single returns + \$1, 800 x 460, 000 joint returns = \$885 million)			
Total			1, 580, 000
IV. <u>Federal Tax Base</u> (61% of A.G.I.)			
Wages and Salaries	887, 000	773, 000	1, 660, 000
Proprietors Income	157, 000	135, 000	292, 000
Total	1, 044, 000	908, 000	1, 952, 000
V. <u>California Tax Base</u> (61% of A.G.I. less \$885 million)			
Total			1, 067, 000

a. Residents and commuters liable for a flat rate earnings tax on income earned within City.

Source: Computed from State Franchise Board and U. S. Bureau of the Census Data.

TABLE C-2

ESTIMATE OF ALTERNATIVE BASES FOR TAX ON ALL EARNED  
INCOME OF SAN FRANCISCO RESIDENTS AND ON COMMUTER  
EARNINGS IN SAN FRANCISCO, 1967

TYPE II INCOME BASE<sup>a</sup>

	<u>Residents</u>	<u>Commuters</u>	<u>Total</u>
	(Thousands)		
I. <u>A.G.I. (Adjusted Gross Income)</u>			
Wages and Salaries	\$1,780,000	\$1,267,000	\$3,047,000
Proprietors' Income	277,000	222,000	499,000
Total	2,057,000	1,489,000	<u>3,546,000</u>
II. <u>A.G.I. less \$600 per capita exemption (77% of A.G.I.)</u>			
Wages and Salaries	1,371,000	976,000	2,347,000
Proprietors' Income	213,000	171,000	384,000
Total	1,584,000	1,147,000	<u>2,731,000</u>
III. <u>A.G.I. Less State exemptions</u> ("II" less \$900 x 63,000 single returns + \$1,800 x 460,000 joint returns = \$885 million)			
Total			1,846,000
IV. <u>Federal Tax Base</u> (61% of A.G.I.)			
Wages and Salaries	1,086,000	773,000	1,859,000
Proprietors' Income	169,000	135,000	304,000
Total	1,255,000	908,000	2,163,000
V. <u>California Tax Base</u> (61% of A.G.I. less \$885 million)			
Total			<u>1,278,000</u>
a. Taxes all earned income of residents regardless of source and income of non-residents earned within City			

Source: Computed from State Franchise Board and U. S. Bureau of the Census Data

TABLE C-3

ESTIMATE OF ALTERNATIVE BASES FOR TOTAL INCOME OF SAN FRANCISCO  
RESIDENTS AND COMMUTER EARNINGS IN SAN FRANCISCO, 1967

TYPE III INCOME BASE<sup>a</sup>

	<u>Residents</u>	<u>Commuters</u>	<u>Total</u>
	(Thousands)		
I. <u>A.G.I. (Adjusted Gross Income)</u>			
Wages and Salaries	\$1,780,000	\$1,267,000	\$3,047,000
Proprietors Income	277,000	222,000	499,000
Property Income <sup>b</sup>	<u>514,000</u>	<u>--</u>	<u>514,000</u>
Total	\$2,571,000	\$1,489,000	\$4,060,000
II. <u>A.G.I. less \$600 per capita</u> <u>(77% of A.G.I.)</u>			
Wages and Salaries	1,371,000	976,000	2,347,000
Proprietors Income	213,000	171,000	384,000
Property Income <sup>b</sup>	<u>396,000</u>	<u>--</u>	<u>396,000</u>
Total	\$1,980,000	\$1,147,000	\$3,127,000
III. <u>A.G.I. less State Exemptions</u> <u>("II" less \$900 x 63,000 single</u> <u>returns + \$1,800 x 460,000 joint</u> <u>returns = \$885 million)</u>			
Total			\$2,242,000
IV. <u>Federal Tax Base</u> <u>(61% of A.G.I.)</u>			
Wages and Salaries	\$1,086,000	773,000	1,859,000
Proprietors Income	169,000	135,000	304,000
Property Income <sup>b</sup>	<u>314,000</u>	<u>--</u>	<u>314,000</u>
Total	\$1,569,000	\$ 908,000	\$2,477,000
V. <u>California Tax Base</u> <u>(61% of A.G.I. less</u> <u>\$885 million)</u>			
Total			\$1,592,000

a. Taxes all earned income and property income of residents and income of nonresidents earned in the City.

b. Includes \$128,000 capital gains.

Source: Computed from State Franchise Board and U.S. Bureau of the Census Data.

## MUNICIPAL INCOME TAX BASES, JANUARY 1, 1964

State	<u>Individuals</u>		<u>Unincorporated Business</u>		<u>Corporations</u>
	Salaries and wages and other compensation for personal services		Net profits		Net profits from activities conducted within city located on basis of--
	Residents	Non-Residents	Residents	Non-Residents	
	Income earned within city regard- less of origin <sup>1</sup>	Income earned within city	Activities conducted within city	Activities conducted wherever within city	(1) Prop- erty re- cepts (2) Gross re- cepts (3) Pay- rolls
Alabama: Gadsden <sup>2</sup>	X	X	X	X	X
Kentucky: 2					
7 cities and 1 county <sup>3</sup>	X	X	X	X	
6 cities <sup>4</sup>	X	X			
Michigan: 3 cities <sup>5</sup>	X	X		X	X
Missouri: St. Louis and Kansas City	X	X		X	X
Ohio cities	X	X		X	X <sup>6</sup>
Pennsylvania local governments	X	X <sup>7</sup>		X	X <sup>7</sup>

1. Various types of intergovernmental tax crediting or reciprocity arrangements are employed in Ohio and Pennsylvania, to avoid double taxation.

2. The taxes in Gadsden, Alabama, and in Kentucky cities are imposed as occupational license taxes.

3. Cattlesburg, Frankfort, Lexington, Louisville, Owensboro, Pikesville, Princeton, and Jefferson County.

4. Covington, Hopkinsville, Mayfield, Maysville, Paducah, and Newport. In most of these cities businesses and professions are taxed under a separate business license tax.

5. Detroit, Flint, and Hamtramck.

6. Dayton substitutes for the payroll factor total production costs.

7. School districts in Pennsylvania are not allowed to tax nonresidents.

Source: Advisory Commission on Intergovernmental Relations



## APPENDIX D

### SALES TAX BURDEN AS PERCENT OF MONEY INCOME: MAJOR STATE STUDIES<sup>a</sup>

<u>Income Class</u>	<u>State Tax Studies</u>			
	<u>California (Hickman)</u>	<u>California (Graves)</u>	<u>Maryland</u>	<u>Michigan</u>
Less than \$1,000	2.40	(b)	(b)	(b)
\$1,000 - 2,000	2.23	2.12	1.56	5.03
2,000 - 3,000	1.99	1.67	1.04 <sup>c</sup>	3.31
3,000 - 4,000	2.02	2.04	-	2.77
4,000 - 5,000	1.88	1.77	1.00 <sup>d</sup>	2.22
5,000 - 6,000	2.12	1.86	-	-
5,000 - 7,000	-	-	-	2.08
6,000 - 7,500	2.28	2.16	-	-
7,000 - 10,000	-	-	.95 <sup>e</sup>	1.75
7,500 - 10,000	1.93	1.81	-	-
10,000 and over	1.84	-	.74	1.25
10,000 - 15,000	-	1.68	-	-
15,000 and over	-	2.04	-	-

a. Income concepts: California (Hickman) - money income (after taxes), California (Graves) - personal income, Maryland - money income (before taxes), Michigan - money income (before taxes).

b. Computed for under \$2,000 bracket only.

c. Computed for \$2,000 - \$4,000 bracket only.

d. Computed for \$4,000 - \$6,000 bracket only.

e. Computed for \$6,000 - \$10,000 bracket only.

Note: See footnote 9 to Chapter 6 for full citations of studies listed above.

Source: William H. Hickman, Distribution of the Burden of California Sales and Other Excise Taxes (Sacramento, 1958), Table 4, p. 13; California Tax Study, Table XXX, p. 45; Maryland Tax Study, Table 9.2, p. 81; Michigan Tax Study, Table 5, p. 138.

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